February
1984

Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget —Part III

As Required by Public Law 93-344

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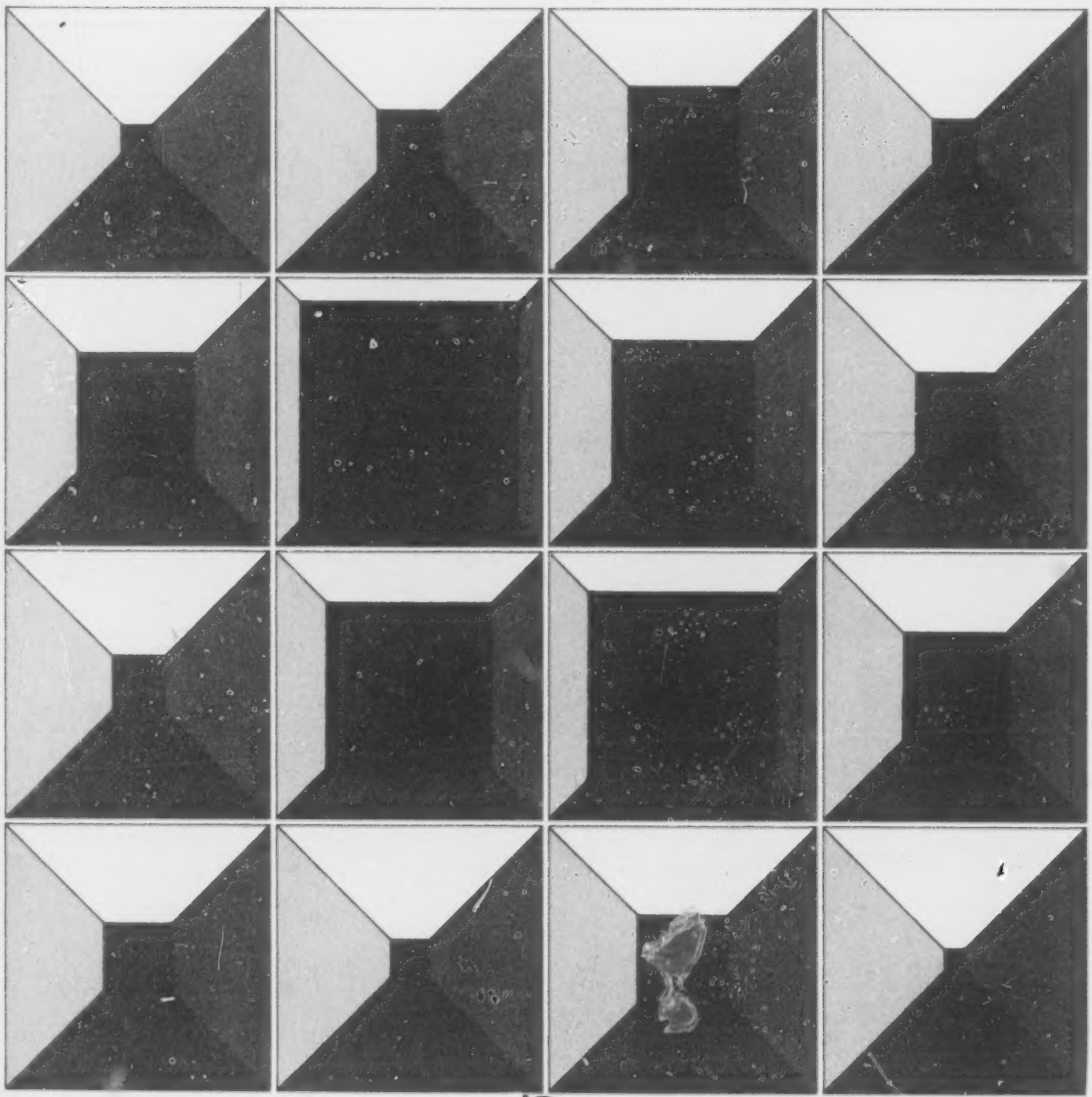

CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

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REDUCING THE DEFICIT:

SPENDING AND REVENUE OPTIONS

The United States Congress
Congressional Budget Office

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NOTES

Unless otherwise noted, all years referred to in this report are fiscal years. Likewise, unless otherwise noted, all dollar amounts are expressed in current dollars.

Details in the text, tables, and figures of this report may not add to the totals because of rounding.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in three parts, with this report constituting Part III. Part I is entitled The Economic Outlook; Part II is Baseline Budget Projections for Fiscal Years 1985-1989. This report provides background information for each major spending area of the budget and for revenues, and analyzes various specific options that would reduce the deficit. The inclusion of an option in this report, or the omission of one, does not imply a recommendation by CBO. In accordance with CBO's mandate to provide objective and impartial analysis, this report contains no recommendations.

All divisions of the Congressional Budget Office contributed to this report, which was prepared under the general supervision of Robert W. Hartman. Alfred B. Fitt was responsible for Chapter I; John J. Hamre for Chapter II, with major assistance from Edward A. Swoboda; Lisa Potetz for Chapter III, with major assistance from Hinda Ripps Chaikind; Paul Cullinan for Chapter IV, with major contributions from Charles E. Seagrave; Robert A. Sunshine for Chapter V, with major assistance from Martin D. Levine and Everett M. Ehrlich; Joseph J. Minarik for Chapter VI, with major assistance from the Joint Committee on Taxation. Authors of specific options are listed in Appendix B.

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Rudolph G. Penner
Director

February 1984

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Appendix A-1, beginning on page 244, arranges the spending reduction options in this volume by budget function, and for each one shows the savings it would achieve and the page at which it may be found. Appendix A-2, beginning at page 268, serves the same purpose for revenue increase options.

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CHAPTER I. INTRODUCTION

This is the fifth in a series of annual reports by the Congressional Budget Office (CBO) describing ways by which the Congress might reduce the federal deficit. Last year's report projected steadily larger deficits over the years 1984 through 1988, with a $284 billion gap between total spending and revenues in the final year. The risks to the American economy posed by such deficits were characterized as "cause for alarm."

The budget projections this year resemble those made in early 1983, carried one year further: the prospect still is for persistent and rising total deficits of a size without peacetime precedent, reaching $339 billion in 1989. So the risks are the same as well, but the time to deal with them has been shortened by 12 months. The government is on a course for which our country's history provides no charts.

THE CBO BASELINE BUDGET

A beginning point for budgeting--or for making decisions whether and how to reduce the federal deficit--is to make a projection of what the future will hold if all current policies are continued, and if the economy behaves according to given assumptions. CBO's most recent projection of this kind--its baseline budget--is displayed in Table I-1. The table shows total deficits rising steadily over the 1985-1989 period, both absolutely and as a percentage of gross national product (GNP), from a low of 5.3 percent in 1985 to 6.3 percent at the end of the period.

In the 38 years since World War II, the total deficit has exceeded 3.0 percent of GNP only four times, all during years of high unemployment: in 1975, 1976, and 1982, when it was 4.5 percent or less; and in 1983, when it reached 6.4 percent. Now the projection is for record-breaking peacetime deficits year after year even in times of relative prosperity. If the current economic rebound falters, the deficits will be even larger than those shown in the table. 1/

1. For a discussion of the assumptions in the CBO baseline projection, see Congressional Budget Office, The Economic Outlook (February 1984) and Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984).

TABLE I-1. BASELINE BUDGET PROJECTIONS (By fiscal year)

	Estimated 1984	Baseline Projections 1985	1986	1987	1988	1989
			In Billions of Dollars			
Revenues	663	733	795	863	945	1,016
Budget Outlays a/	853	928	1,012	1,112	1,227	1,342
Budget Deficit	190	195	217	248	282	326
Off-Budget Outlays	13	13	13	14	13	13
Total Deficit	203	208	230	262	295	339
			As a Percent of GNP			
Revenues	18.6	18.7	18.7	18.7	19.0	18.9
Budget Outlays a/	23.9	23.7	23.8	24.1	24.6	24.9
Budget Deficit	5.3	5.0	5.1	5.4	5.6	6.1
Off-Budget Outlays	0.4	0.3	0.3	0.3	0.3	0.2
Total Deficit	5.7	5.3	5.4	5.7	5.9	6.3

SOURCE: Congressional Budget Office.

NOTE: Assumes 5 percent real growth in defense budget authority.

a. **Budget outlays** are unified budget outlays. **Gross outlays** are budget outlays plus offsetting receipts. **Total spending** is the sum of budget and off-budget outlays.

THE COMPOSITION OF THE BASELINE

The projections in Table I-1 show tax receipts hovering near 19.0 percent of GNP for the entire 1984-1989 period, but budget outlays will rise from about 23.9 percent of GNP this year to 24.9 percent in 1989.

Within the annual totals, there is little change on the revenue side in the relative shares attributable to the major sources of tax receipts, but on the spending side marked shifts occur (see Table 1-2). Defense, Medicare, and net interest will command larger shares in 1989 than they do now, if current policies continue, while the other major spending categories will decline as a percent of GNP.

TABLE I-2. BASELINE BUDGET OUTLAY PROJECTIONS AS A PERCENT OF GNP (By selected fiscal years)

	1984	1987	1989	Percent Change 1984 to 1989
National Defense a/	6.6	7.2	7.8	+18.2
Entitlements and Other Mandatory Spending				
Social Security	4.9	4.6	4.5	-7.3
Medicare	1.8	2.0	2.2	+22.9
All other	4.6	4.0	3.8	-14.9
Nondefense Discretionary Spending	4.4	3.9	3.7	-15.9
Net Interest	3.0	3.6	4.1	+33.9
Offsetting Receipts	-1.3	-1.2	-1.2	-8.2
Budget Outlays	23.9	24.1	24.9	+4.3

SOURCE: Congressional Budget Office.

a. Assumes 5 percent real growth in defense budget authority.

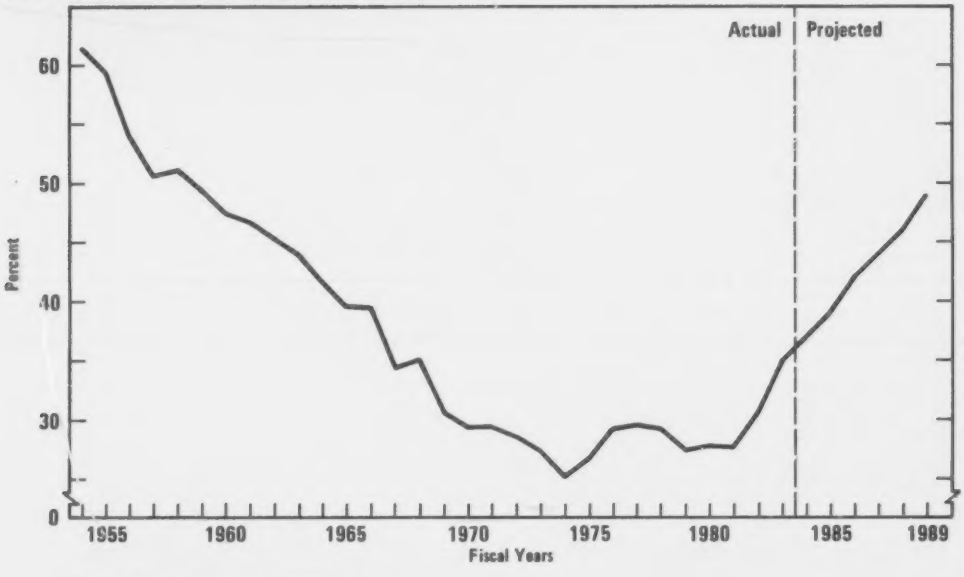
LARGE DEFICITS AND THEIR CONSEQUENCES

Beginning with fiscal year 1982 and continuing every year as far as the projection is cast, the federal debt rises more rapidly under current policies than does GNP (see Figure I-1). Carried on long enough, such a course would ultimately mean 100 percent of GNP devoted to paying annual interest on the federal debt. Since that outcome is an absurdity, the only questions are how, and how soon, the government will move to reverse a course that must be reversed.

As to how soon the reversal should occur, the answer depends on how one evaluates the threats that prospective deficits pose to the country. Those threats are several.

First, the 1984-1989 addition of over $1.3 trillion in public debt means that a growing fraction of taxpayer dollars will be used to pay interest, not to purchase public services. Interest on the debt held at about 7 percent of gross outlays for many years until it began to climb in the late 1970s. Last

Figure I-1.
Debt Held by the Public (Excluding Federal Reserve) as a Percent of GNP, Year End



SOURCE: Congressional Budget Office.

year it was 10.7 percent, and CBO projects it will reach 15.6 percent in 1989. Thus, to pay for any given level of public services from the national government will require more taxpayer dollars than would be the case were future deficits lower.

Second, as government borrowing draws more heavily on the capital market, it is likely to raise real interest rates and impede expansion in interest-sensitive sectors of the economy. For the most part, such sectors undertake substantial investment: construction (for example, homes), equipment, durable consumer goods such as autos, and state and local capital spending for schools, water treatment plants, highways, and the like. If such investment is reduced over the next five years, the legacy of capital to future generations will be less, lowering potential output and standards of living.

Third, while the rise in interest rates and the fall in investment may be reduced by foreigners lending to the United States, the long-run effect on our standards of living will nevertheless be adverse. Large volumes of capi-

tal from abroad augment the domestic savings pool and reduce the extent to which government borrowing drives up interest rates. But the interest and dividends that must flow to foreign investors will ultimately be used to purchase exports of goods and services from the United States. Thus, even if future U.S. output is maintained, Americans will consume less of it as an enduring consequence of foreign capital inflows.

Finally, continuing high deficits can make the conduct of monetary and trade policy more difficult and raise the risks of default by nations with large foreign debts. High real interest rates and the accompanying strong exchange value of the dollar imply an unbalanced economic growth pattern at best. American importers may prosper, but U.S. capital goods producers, export industries, and products facing import competition will all suffer, creating pressures on the Federal Reserve to ease credit and on the Congress to tighten import restrictions. Similar pressures are put on the central bank by debtor nations unable to service debt at high interest rates.

But the Federal Reserve, faced with high credit demands emanating both from the economic recovery and from large-scale federal borrowing, must tread a narrow path. It cannot depress real interest rates artificially over a sustained period without creating an inflationary danger. Conversely, it must be wary of the other danger, that high real interest rates will choke off the recovery prematurely.

Some may think the CBO baseline economic assumptions are too pessimistic, holding that the threats described above will be avoided by more rapid economic growth. But the CBO baseline assumes seven years of uninterrupted growth, averaging 4.0 percent, from the recession trough in December 1982 through 1989--precisely the same as the average seven-year growth rate following previous recessions since World War II.

The highest average GNP growth rate over any such period was 4.9 percent, from 1962 through 1968. CBO has calculated a high-growth path incorporating that rate (along with somewhat higher inflation and somewhat lower interest rates), the details of which may be found in Chapter IV of Baseline Budget Projections for Fiscal Years 1985-1989. This high-growth path results in a 1989 total deficit in the neighborhood of $200 billion. Such a deficit, equal to 3.4 percent of GNP, would be without precedent after so prolonged a period of prosperity.

In short, prudence suggests that if the projected deficits are to be brought down significantly, this will occur only through spending cuts or higher taxes or some combination of the two. The remainder of this volume is devoted to that subject.

SETTING A DEFICIT REDUCTION TARGET

A difficulty with fixing a deficit reduction target is that any choice will to some extent be arbitrary. This is because no broadly held theory purports to prescribe an optimum fiscal policy path for the United States to follow between now and 1989. Nevertheless, some choice must be made soon, both as to amount and as to timing, if the desired result is to be achieved in the target year; to make no choice at all is a decision to run all the risks inherent in the baseline projection.

Last year the 98th Congress set a 1986 deficit target for the unified budget of about 3.0 percent of GNP as it was then projected for that year. If a deficit equal to 3.0 percent of GNP is again taken as the goal for the third year, the 1987 unified budget deficit will have to be brought down to $138 billion from the projected $248 billion, a difference of $110 billion. The reduction itself would amount to about 2.4 percent of GNP.

Federal unified budget deficits during the 1970s averaged 1.9 percent of GNP. If this were chosen as the standard for 1987, the target deficit would be $88 billion, or $160 billion less than the baseline deficit.

THE COMPOSITION OF DEFICIT REDUCTION

Deciding on a 1987 deficit target requires a selection among goals, no one of which is clearly superior to all the others. The only certainty is that the deficit should not continue to rise relative to GNP, and some move back toward lower levels seems eminently desirable. Once a goal is selected, however, there remains the formidable task of deciding the means to reach whatever target has been chosen.

Any 1987 deficit reduction target large enough to reverse, or even to arrest, the alarming trends shown in the baseline projections, will mean higher costs in the form of taxes or lower services from the federal government--or both--for the American people. There are no painless solutions. The Congress and the President will have to choose which spending commitments are to be scaled back and which additional tax burdens are to be borne.

The Dimensions of the Task. Current policies call for rising budget shares for national defense, health services, and interest payments, and declining shares for all other major budget categories (see Table I-3). The composition of those major budget categories is described in the box on the facing page.

FEDERAL BUDGET CATEGORIES

National Defense. Outlays for military and civilian personnel, operating costs, and major weapons procurement. Military and civilian workers' pay increases are included in the projections.

Entitlements and Other Mandatory Spending. Programs in which spending is governed by a law making all who meet their requirements eligible to receive payments. Subcategories are:

> **Social Security.** Old-age, survivors, and disability benefits only. Medicare is in the next category and administrative expenses are in the nondefense discretionary category.
>
> **Medicare and Medicaid.** Does not include state share of Medicaid expenditures. Federal administrative expenses for Medicare are in the nondefense discretionary category.
>
> **Farm Price Supports.** All outlays of the Commodity Credit Corporation for farm price support and related programs.
>
> **Other Entitlements.** Entitlements and other mandatory spending not included above or in "Net Interest." Major examples are Aid to Families with Dependent Children, Black Lung compensation, railroad retirement, federal civilian and military retirement, Guaranteed Student Loans, human services block grants, Supplemental Security Income, unemployment compensation, veterans' compensation and pensions, and General Revenue Sharing. The Food Stamp program has also been included in this category.

Nondefense Discretionary Spending. All nondefense programs for which spending is determined by annual appropriations. The basic governmental legislative, judicial, and tax-collecting functions are included. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of government. Most grants to state and local governments (other than for benefit payments), nondefense research and development, and loans subject to appropriation limits are also in this category.

Net Interest. Interest payments on the federal debt less interest received by trust funds.

Offsetting Receipts. Proprietary receipts from the public and the employer share of employee retirement. Other receipts (for example, foreign military sales, trust fund receipts, and payments to trust funds) appropriately netted against outlays are included in the relevant categories above.

TABLE I-3. PROJECTED BUDGET OUTLAYS BY MAJOR CATEGORY, 1984 AND 1987 (In billions of dollars)

	1984	1987	Percent Change 1984 to 1987
National Defense a/	235	331	41.1
Entitlements and Other Mandatory Spending			
Medicaid	21	27	31.9
Other means-tested benefits	40	45	10.6
Social Security	173	211	21.5
Medicare	64	94	45.3
Other nonmeans-tested programs	101	114	12.7
Nondefense Discretionary Spending	156	178	13.8
Net Interest	108	168	55.2
Gross Outlays	899	1,167	29.8
Offsetting Receipts	-46	-55	18.6
Budget Outlays	853	1,112	30.4
Reference: GNP	3,563	4,612	29.4

SOURCE: Congressional Budget Office.

a. Assumes 5 percent real growth in defense budget authority.

In dollar terms, about 76 percent of projected 1987 gross outlays will be in defense, Social Security and other retirement programs, Medicare-Medicaid, and interest. If these categories are not cut--and interest, of course, can only be attacked indirectly--and if taxes are not raised, achieving a 1987 deficit equal to 3.0 percent of GNP would leave the remaining categories at about 60 percent of their projected 1987 levels, even though, as the final column of Table I-3 shows, their share of GNP is already scheduled to decline.

The foregoing suggests that, if the spending path is to be altered significantly, current defense or entitlement policy--or both--will have to be

changed. As for defense spending, the Administration is urging 1985-1987 appropriations averaging 6.4 percent above the CBO baseline, not a promising beginning to enactment of a defense program below the baseline.

A different problem attaches to Social Security, by far the largest of the entitlements. The Social Security Amendments of 1983 put that program on a course projected to maintain the financial soundness of the system for many decades. If further Social Security benefit cuts should now be enacted, without reducing payroll taxes, the likely resulting trust fund surplus would contribute toward reducing the overall deficit. Many would object that having altered Social Security so recently, further reductions in promised benefit growth would be unfair. But to accept this argument is to place nearly 20 percent of gross outlays off limits in developing a deficit reduction plan.

Looking elsewhere in the budget, Medicare spending is second only to interest in speed of growth between 1984 and 1987. If this program is to contribute toward spending reduction, the unavoidable consequence must be higher health care costs for the elderly, or lower payments to health care providers, or lesser use of health care services, or higher costs for state and local governments, or some combination of these outcomes.

Federal highway spending is another growing program and in 1987 will account for 8.2 percent of all nondefense discretionary outlays. Cutting back on such spending will mean a reversal of decisions made in the Surface Transportation Act of 1982, and highway users will not see all the improvements for which they have been paying an extra 5 cents a gallon tax since April 1983.

The point of the foregoing is not to demonstrate that defense, Social Security, Medicare, and highway spending growth cannot be restrained; rather, it is that in those programs, and in hundreds of others, powerful arguments--whether in terms of sheer political difficulty or social costs or lost investment opportunities--can be mounted in favor of continuing instead of abandoning current policies. Many would argue that only a comprehensive deficit reduction plan with the costs spread widely over the budget, and with no single category bearing what can fairly be perceived as a disproportionate share of those costs, will prevail against the momentum of programs now in place.

Deficit reduction: How much by spending cuts and how much by tax increases? In theory, at least, the chosen target deficit could be reached entirely by enacting higher taxes or entirely by lowering spending. However, if all the burden of deficit reduction is placed on one side of the

budget to the exclusion of the other, the changes required in either spending or tax policies will be very much more radical than if the burden is spread over both sides.

To use only the tax side to reach a 3.0 percent of GNP deficit target in three years would require very large tax increases, resulting in an overall federal tax burden of 21.0 percent, slightly higher than the 20.9 percent of GNP reached in 1981, the peak taxing level in U.S. peacetime history. To the extent that marginal rates were raised as part of the package, there would also be the prospect of an adverse impact on economic efficiency.

Achieving a similar target deficit only by spending cuts would, if it were done across the board, mean a cut of about 10 percent in gross, non-interest spending. Because contractual commitments from prior years must be kept, many programs would have to suffer an even greater percentage decrease. This would require a fundamental change in U.S. defense policies and in the promises inherent in the entitlement programs.

More generally, decisions regarding how much and where to cut spending depend on collective judgments regarding the basic responsibilities of government. Put another way, it is necessary to decide whether an additional dollar spent by government can be put to better use than an additional dollar spent by the taxpayer. Some roles for government are relatively noncontroversial. The defense of the nation, the maintenance of law and order, and the provision of a public investment infrastructure are examples of roles that are generally accepted, although deciding the amounts to be spent on each is still contentious. Issues regarding income redistribution and the allocation of responsibilities among federal, state, and local governments often become even more politically divisive, with different citizens having very different views as to how much of a role the federal government should play.

But, whatever the role chosen for government, it must be paid for. While a portion of spending can be covered by borrowing, the debt-to-GNP ratio cannot rise continually. Eventually the growth in debt must be restrained. However, no amount of analysis can demonstrate that a particular mix between raising taxes and cutting spending is the correct mix for restraining the deficit. Whatever mix might finally be chosen must necessarily depend on subjective, political judgment.

Building to a deficit reduction target. The following examples suggest how difficult it will be to achieve a major reduction in the 1987 and future year deficits:

- If defense is held to zero real growth beginning in 1985, the 1987 savings will be $25 billion.

- If the 1985 cost-of-living adjustment in all indexed programs is skipped, the 1987 savings will be $12 billion.

- If income tax indexing is repealed, 1987 revenues will be up by $31 billion.

- If a 1 percent comprehensive national sales tax is imposed in 1987, it will raise about $16 billion.

All of the listed examples are controversial; all would certainly be among the largest items in any compendium of deficit reduction items. But if all were enacted, the combination would still leave the 1987 unified budget deficit at 3.3 percent of GNP.

USE OF THIS VOLUME

The five succeeding chapters are devoted to Defense, Medicare-Medicaid, Social Security and Other Entitlements, Nondefense Discretionary Spending, and Revenues. Each begins with a general discussion of the subject of the chapter and is followed by a more detailed description of actions the Congress might take either to reduce spending or to increase revenues. In all, 138 options are listed, 98 on the spending side and 40 on the taxing side.

Because this is a volume about ways to reduce the federal deficit, each of the options necessarily calls for lower spending or higher taxes. The Congressional Budget Office, however, takes no position with respect to what the size of the federal government or its deficit should be; those are decisions to be made by the Congress and the President. Consequently, the inclusion of an option--or the omission of one--does not constitute a recommendation by CBO. The merits and demerits of each are presented, but only in brief terms, and CBO has no view as to which outweighs the other.

The reader should bear several cautions in mind. The separate options cannot be added to a grand total. A number of them are mutually exclusive, so that summing them would produce a meaningless figure. The savings effects of each are calculated separately, as if none of the other options were to become law, but in fact there would be interactions among the options if many of them were enacted, so that the consequences of enacting a package would be different from enacting each of its components in isolation.

The deficit reductions discussed in this volume represent only a first approximation of savings that might actually be realized. Variations on any particular option can, of course, be used to vary the savings it is likely to achieve. In some instances, a reduction in one program might result in program expansion elsewhere. Reducing Social Security benefits, for example, would generally increase payments from other programs such as Supplemental Security Income and Food Stamps. In most cases, unless otherwise specified, these offsetting effects are not included in the estimates presented in this report.

Any enduring reduction in outlays or increase in revenues will ultimately result in a lower public debt, and therefore in lower net interest outlays than would otherwise be the case. Thus, an annual savings of $2 billion in a program would reduce the projected public debt outstanding by $10 billion in five years and--at CBO's projected interest rate--would lower net interest outlays by $1.1 billion in the fifth year. While one could calculate such savings for any particular deficit reduction measure, the number would not be particularly useful, for it would depend entirely on how many years of cumulative deficit reductions are assumed. The useful number is the net impact on interest outlays stemming from the whole budget enacted by the Congress. Therefore, the options in the chapters that follow do not include the induced interest savings.

The economic assumptions for the later years of the CBO baseline budget projections represent a plausible path for the economy to take. These assumptions are consistent with a variety of fiscal policies, given likely adjustments in monetary policy in reaction to fiscal policy changes. Consequently, a policy change from the baseline budget should not be presumed necessarily to affect the economic assumptions used. On the other hand, a budget change might conceivably be so major as to warrant revisions of the assumed economic path. In this report, all deficit reduction options are estimated under the CBO baseline economic assumptions without any such feedback effects.

CHAPTER II. NATIONAL DEFENSE

The Administration is proposing real increases in national defense budget authority for the sixth consecutive fiscal year. Under the Administration's plans, 31 percent of the federal budget authority in fiscal year 1985 will be devoted to national defense, with that proportion growing to 34 percent by 1989. This year's request is $16 billion more than the amount the Congress specified last year that it intended to provide for national defense in 1985. This chapter discusses various options for reducing national defense expenditures.

BACKGROUND

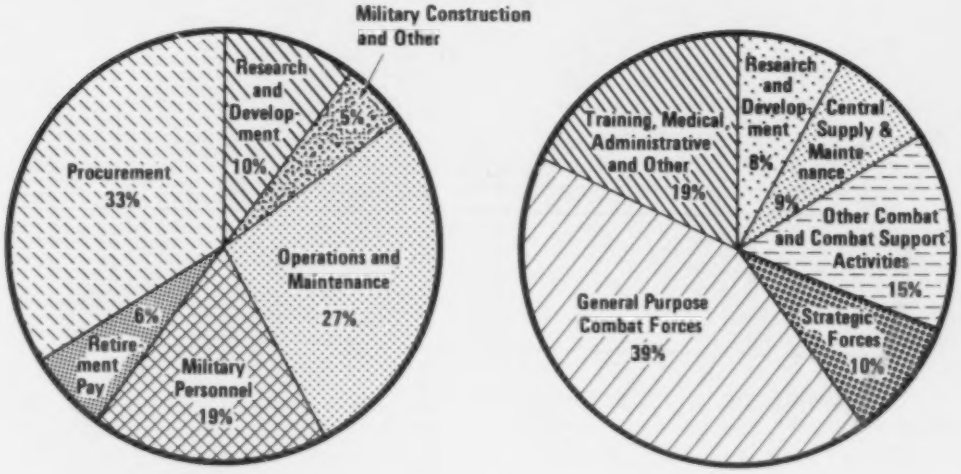
The national defense portion of the federal budget provides funds for the operation and training of existing armed forces and for the purchase of new equipment and facilities to improve and expand the capabilities of those forces. Department of Defense (DoD) spending makes up the bulk of national defense spending. Other expenditures that are arguably part of the costs of defense, though not included in this chapter, are veterans' benefits (see Chapters IV and V) and most of the retirement costs of DoD civilian employees (see Chapter IV).

Over half of the total DoD budget authority for 1984 provides compensation for military personnel, military retirement, and funding for the operations and maintenance (which includes civilian pay) of existing equipment and facilities (see Figure II-1, Part A). These operating accounts fund pay and allowances, combat training and exercises, most maintenance and repair activities at extensive DoD-owned and commercial industrial facilities, and operations at more than 5,000 installations and properties in the United States and overseas. The cost of military activities in Lebanon, Grenada, and Central America, as well as routine deployment of naval forces and ground forces in Europe and Korea, also are funded through these operating accounts.

The remaining budget authority--generally called the investment accounts--pays for ongoing research, development, and production of new combat equipment, and construction of new facilities. Procurement of new combat and support equipment is by far the largest category, projected at 33 percent of total 1984 budget authority.

Part B of Figure II-1 shows DoD budget authority by military missions, using standard DoD definitions. Each of these activities requires funding for

Figure II-1.
Fiscal Year 1984 Defense Budget (Budget Authority)



operations and maintenance and pay for military and civilian personnel assigned to the activity. To a varying degree, each mission activity also requires procurement, military construction, and research and development (R&D) funding. Based on DoD accounting categories, strategic nuclear forces, while prominent in the defense debate, require a relatively small portion (10 percent) of total defense budget authority in 1984 though that portion is highly concentrated in investment accounts. General purpose forces and other combat-related activities (such as communications and intelligence, Reserve and National Guard forces, and mobility forces) will receive 54 percent of the DoD funds in 1984. Support activities--such as central logistics support and basic training--absorb the remaining 36 percent.

RECENT BUDGET HISTORY AND THE ADMINISTRATION'S 1985 PROPOSAL

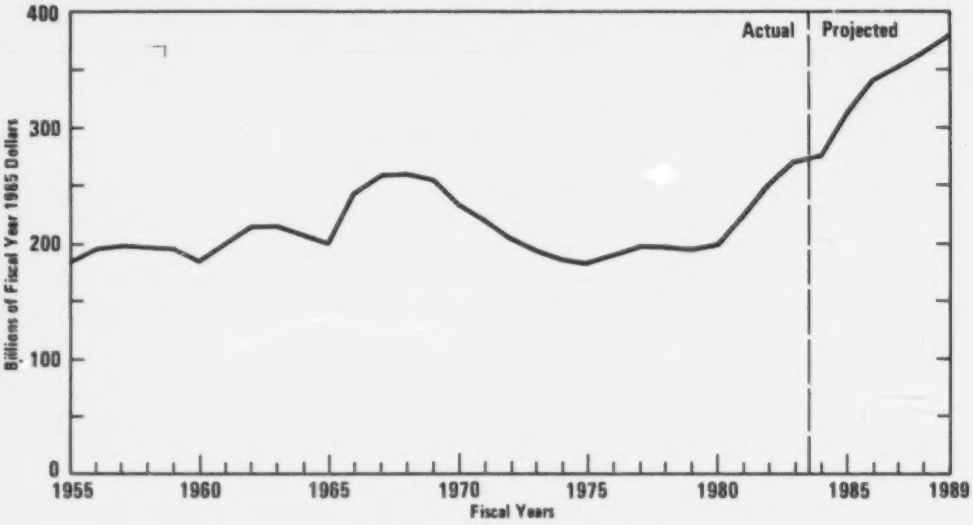
Trends in the 1970s

Defense budget authority declined significantly in real terms (that is, adjusted for inflation) during the first half of the 1970s, following the peak

of the Vietnam War. A turning point came in 1975. Substantial real increases in defense spending occurred during the latter half of the decade and have continued to the present (See Figure II-2).

Figure II-2.

Budget Authority for National Defense (In Constant 1985 Dollars)



SOURCE: CBO calculations based on data from the Department of Defense.

This overall trend is reflected in important changes within the military forces themselves. Through the 1970s, numbers of strategic nuclear forces remained relatively unchanged, except for a halving of the number of aircraft committed to continental air defense and a relatively moderate decline in strategic bombers. Throughout this period, however, substantial qualitative improvements occurred in strategic forces, for example, by installing multiple warheads on strategic missiles.

The real declines in the 1970s took place among conventional or general purpose fighting forces. Between 1970 and 1975, Army maneuver battalions, Navy ships, and tactical aircraft declined by 20 to 35 percent. While cuts in the Army and Air Force largely ended after 1975, the number of ships continued to drop. Total military and civilian manpower also fell sharply in the early part of the 1970s from the high levels of the Vietnam War. The downward trend continued, but much more moderately, in the latter half of the 1970s. In sum, by the end of the 1970s, the United States

generally had fewer armed forces, though the quality of those forces had improved significantly. Moreover, spending trends already under way in the late 1970s suggested that further qualitative improvement and some expansion of forces would occur in the early 1980s.

Trends Under the Current Administration

The Reagan Administration dramatically accelerated these trends, making higher defense spending a primary objective. Defense outlays have increased from $160 billion in 1981 to an estimated $235 billion in 1984, an increase of 47 percent (25 percent in real terms). Budget authority--a better measure of the commitments assumed through the defense buildup--has increased 45 percent (25 percent in real terms) in just three years. (Budget authority establishes the legal right to make spending commitments. Actual defense expenditures, called outlays, often lag behind budget authority by several years because of the time needed to build weapons.) While all categories of defense purchases have increased, primary emphasis has been placed on purchasing new weapons systems; budget authority for procurement has increased 78 percent since 1981 (48 percent in real terms). All types of military equipment are being purchased, though particular emphasis has been given to modernizing strategic forces and expanding the size of the Navy. Though the Administration plans significant increases, defense spending under these plans would still require a smaller percentage of GNP than was typical in the 1950s and 1960s (see Figure II-3).

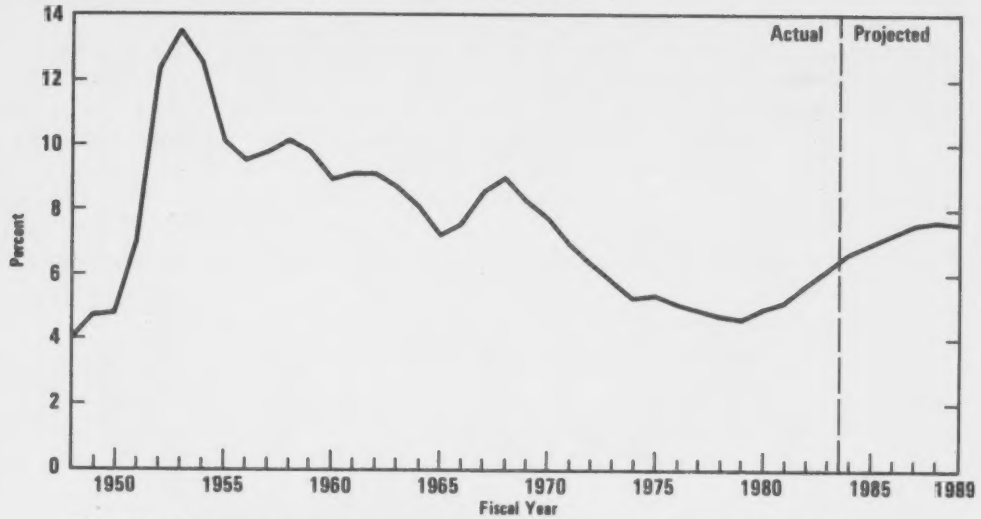
While apparently still favoring continuation of the Administration's defense buildup, the Congress has been slowing the pace of that buildup. Changes in "real growth" reflect this shift. (Real growth refers to percentage increases in defense budget authority in excess of that required to compensate for projected inflation in the defense sector. DoD inflation assumptions are higher than used generally in the budget.) As Figure II-4 indicates, the Congress generally concurred with the Administration's budget request in 1981 and 1982. In the face of mounting deficits, however, the Congress scaled back more recent Administration proposals. It cut in half the real rate of growth requested in 1983 and provided only one-third of the real increase requested for 1984. But the Congress continues to support higher real levels of defense spending, albeit more modest levels than proposed by the Administration. The 1984 budget resolution provided an annual real growth rate of 5 percent in defense budget authority, though the 1984 defense appropriations fell short of this mark.

The Administration's 1985 Defense Request

The Administration's 1985 budget proposal for defense would require $313.4 billion in budget authority and $272.0 billion in outlays for 1985, with

Figure II-3.

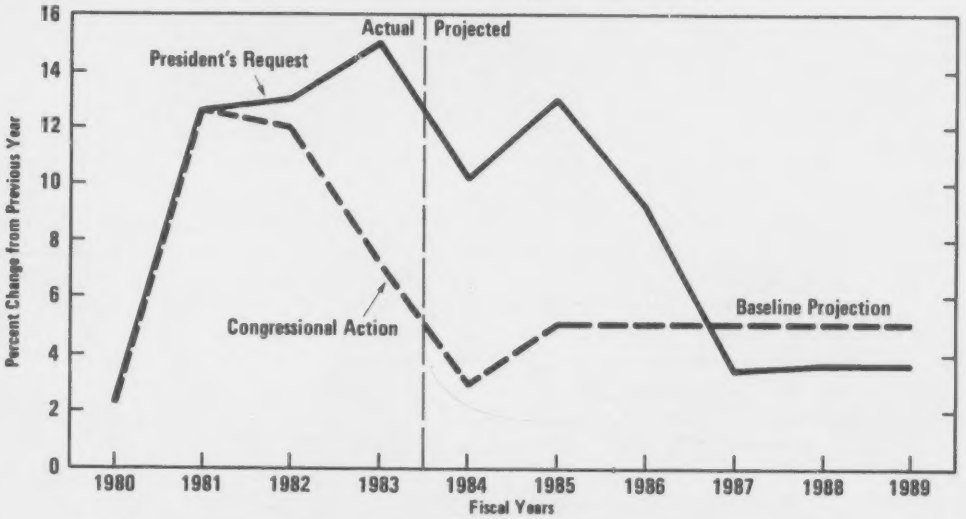
National Defense Outlays as a Percent of GNP



SOURCES: For historical data, Department of Defense; for projections, *Budget of the United States Government, Fiscal Year 1985.*

Figure II-4.

Real Growth in National Defense (Budget Authority)



SOURCE: CBO calculations based on data from the Office of Management and Budget.

continuing increases thereafter, as shown in Table II-1. This represents a 13 percent real increase over 1984, and an average annual real growth of 6.7 percent in 1985-1989 using Administration economic assumptions. This paper had to be sent for publication before it was possible to reestimate the Administration's budget using CBO inflation assumptions. The Administration assumptions in the national defense area differ significantly from CBO assumptions. Those differences will be explained in detail in the forthcoming An Analysis of the President's Budgetary Proposals for Fiscal Year 1985. The discussion of the Administration's budget and alternative rates of real growth in this chapter assumes Administration defense inflation assumptions. The remainder of the chapter is based on CBO defense inflation assumptions.

TABLE II-1. ALTERNATIVE LEVELS OF DEFENSE SPENDING
(By fiscal year, in billions of dollars)

Spending Level	Actual 1980	Actual 1983	Estimated 1984	Baseline Projection 1985	1986	1987	1988	1989
CBO Baseline--1984 Budget Resolution Extended a/								
Budget Authority	146	245	264	297	329	371	419	474
Outlays	136	211	235	263	295	331	372	419
Administration's Request								
Budget Authority	146	245	265	313	359	389	422	456
Outlays	136	211	238	272	311	349	380	409

a. The CBO baseline is an extension of the 1984 Congressional budget resolution. (The baseline figures for 1985 and 1986 were specified in the budget resolution, and are amended here only to reflect more current economic assumptions. Beyond 1986, the CBO baseline expands real defense budget authority by 5 percent a year, consistent with the assumptions for 1985 and 1986 embodied by the 1984 resolution.) The inflation assumptions differ in these two estimates. Differences will be explained and projections reestimated in the forthcoming An Analysis of the President's Budgetary Proposals for Fiscal Year 1985.

STRATEGIES TO REDUCE DEFENSE SPENDING

The Congress always debates defense spending on two levels. At one level, it broadly debates the amount of resources that should be devoted to national security compared with other spending priorities of the federal government. At a more detailed level, it examines particular programs of the defense budget--for example, the desirability of proceeding with the MX missile.

The Administration's request presents a significant challenge to the Congress. The massive deficits projected for 1985 and beyond already assume that defense spending will be limited to 5 percent real growth. The Congress would have to cut $23.6 billion in budget authority in 1985 and $174.2 billion over the next five years just to bring the Administration's plans in line with a 5 percent real growth budget. Cuts would have to be even larger if the Congress decided that it must reduce defense spending further (see Table II-2). Far more rigorous efforts would be required to lower the Administration request to 3 percent or freeze it at current real levels. If the Congress wants no real growth, it would have to reduce the 1985 budget authority by $37.4 billion ($425 billion over the five-year period), a reduction significantly larger than either of the large cuts in the last two years and three times larger than the average percentage reduction imposed by Congress over the last ten years.

Alternative Approaches for Spending Reductions

Once the Congress determines the aggregate level of resources it wishes to commit to national defense, it then must identify particular approaches for adjusting the Administration's request to bring it in line with Congressional priorities. Adopting strategies and directing specific cuts to meet lower levels of defense spending requires making difficult judgments about the adequacy of existing forces as well as the scope and urgency of defense requirements. Alternative reduction strategies may have significantly different effects in the timing of their outlay savings, as well as in their impact on combat effectiveness or military readiness. For example, cuts in operating accounts--such as training activity or flying hours for combat aircraft--would offer substantial near-term outlay savings, since the bulk of operating funds authorized in a fiscal year are spent in that fiscal year. Such cuts, however, would directly affect near-term combat readiness. Such reductions may be difficult for the Congress at a time when existing combat forces are deployed more extensively than at any time since the Vietnam War. Further, the savings from these cuts might not carry over to subsequent years, necessitating additional cuts in readiness to meet lower spending targets in the future.

TABLE II-2. SAVINGS UNDER ALTERNATIVE SPENDING ASSUMPTIONS RELATIVE TO ADMINISTRATION REQUEST
(By fiscal year, in billions of dollars)

Spending Level	1985	1986	1987	1988	1989	Cumulative Five-Year Total
Administration's Request						
Budget Authority	313.4	359.0	389.1	421.6	456.5	1936.6
Outlays	272.0	310.6	348.6	379.7	409.1	1720.0
Savings Needed Under Alternative Options						
5 Percent Real Growth						
Budget Authority	23.6	40.0	38.2	36.6	34.5	174.2
Outlays	11.1	21.8	29.0	27.9	23.4	116.0
3 Percent Real Growth						
Budget Authority	29.1	52.1	57.9	65.1	73.2	278.6
Outlays	12.9	27.6	40.5	46.4	50.3	180.6
Zero Real Growth						
Budget Authority	37.4	69.7	86.0	104.8	125.8	425.0
Outlays	15.6	36.2	57.2	72.6	87.6	272.0

SOURCES: Budget of the United States Government, Fiscal Year 1985. It was not possible to reestimate the Administration request consistent with CBO inflation assumptions in time for publication. Therefore the real growth estimates are based on Administration inflation assumptions. This table will be updated in the forthcoming An Analysis of the President's Budgetary Proposals for Fiscal Year 1985.

On the other hand, budget authority cuts in investment categories, and particularly in procurement accounts, would offer relatively small near-term savings in outlays, but these savings would stretch over several years. Eliminating a $1.2 billion naval cruiser, for example, would save only $72 million in outlays in the first year, since only limited work can be accomplished in the first year of funding and it takes from four to six years to build a major vessel. By the same token, cuts in procurement accounts might have only a limited impact on near-term military capability, but would have a potentially significant impact on longer-term capabilities. Further, it is increasingly difficult to impose large reductions in procurement categories, since cuts in procurement could entail reversing commitments to specific weapons programs adopted in the last several years. Having endorsed many major new modernization programs, the Congress has progressively less flexibility to make annual adjustments in procurement categories, without leading to inefficient production rates or politically difficult program terminations.

The Congress confronts a very difficult dilemma in contemplating defense spending reductions. As Table II-2 indicates, relative to the Administration's plans, large reductions must be made over the next few years just to follow a 5 percent spending path which parallels the policy guidelines of the last Congressional budget resolution. Cuts in operating accounts would be most attractive for making large near-term reductions, but such cuts would occur when U.S. combat forces are operating at relatively high peacetime tempos. In contrast, procurement cuts, while not likely to limit near-term combat effectiveness, would not offer substantial near-term outlay savings.

Targeted Reduction Strategies

If the Congress were to hold to its budget resolution path or select even lower spending targets, it would have to choose a number of strategies to achieve significant cuts. The following section contains various examples, grouped into four general categories.

Reduce Rates of Growth in Procurement. The Congress could choose to scale back real growth in procurement accounts. Reductions could be achieved by cancelling selected programs of lower priority, by limiting the rate of increase in future production, or by redirecting modernization efforts along alternative lines. Options II-1 through II-10 illustrate these approaches. All are consistent with sacrificing or delaying modernization in favor of preserving more growth in numbers of forces or in the ability to operate the forces at high peacetime rates. Over a long period, this approach could result in a larger military, with somewhat less capability on a unit basis. Military forces of this character might be more useful in the event of numerous far-flung conflicts occurring simultaneously, rather than in an intense conflict, say in Europe, with the Soviet Union.

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Reductions in this area would also tend to preserve more flexibility to make changes in future defense budgets, since procurement programs tend to lock in spending for many years into the future.

Impose Modest Reductions in Force Structure. The Administration's plans call for increases in current forces, especially in the Navy and Air Force. The Congress could choose to put off some of these increases. Options II-11 and II-12, which illustrate such an approach, could eventually lead to a somewhat smaller military force, but one with more capable weapons systems throughout its units. Such a force might be less able to handle numerous contingencies simultaneously, but could be a more potent force against the Soviet Union. Force structure cuts would offer near-term savings that recur each subsequent year. The options illustrated below represent plausible alternatives, though they do not offer substantial near-term savings.

Limit Growth in Pay and Benefits. Some 40 percent of DoD spending consists of pay and benefits to attract and retain adequate numbers of military and civilian employees. Adjustments in these categories could yield large potential savings, as seen in Options II-13 through II-17. Generally, these approaches try to reduce across-the-board increases in pay and benefits and target a part of the savings to compensate for specific manpower shortages. In a period when the economy is just recovering from unusually high unemployment rates, there are numerous opportunities to reduce costs by targeting pay and benefits.

Limit Real Increases in Selected Accounts. The operation and maintenance appropriation (O&M), research and development (R&D), and supporting procurement subappropriations, while less prominent than the major procurement items, have been a primary focus of annual Congressional reductions. In 1984, for example, over 30 percent of net reductions took place in these accounts. While sometimes the Congress specifies precisely where reductions are to be made, just as frequently it imposes "undistributed" reductions, leaving to the military services the allocation of reduced funding among the vast number of activities and purchases that constitute this category. Options II-18 through II-20 illustrate the level of savings that could be achieved through a decision to moderate the growth of spending in these areas. Unlike other options discussed in this chapter, these three do not constitute programmatic reductions. They are included here, however, since they are approaches the Congress has used in the past and are likely to be important in the 1985 debate.

The remainder of this chapter presents specific examples for budget reductions, organized to follow the reduction strategies discussed in this section. Not all program details had yet been presented to the Congress when this report was sent to the printer. Specific program changes in the

1985 budget relative to last year's plans could alter this discussion. As such, the budget savings shown may need revision.

As noted above, the Administration request exceeds the budget resolution target set last year by $16 billion in 1985. Since the time those targets were set, there have been calls for even greater spending restraint in order to reduce the massive projected deficits. Should larger cuts be desired, a more radical departure from the Administration's defense plans would be necessary. Freezing defense spending at current real levels would reduce budget authority sharply, by as much as $425 billion, in 1985-1989. Such action, however, would entail very difficult decisions, potentially necessitating termination of ongoing investment programs, reductions in forces, substantial changes in pay and retirement policies, and deeper cuts in operating and support funds. Such a freeze could mean dropping some U.S. defense commitments or, at least, accepting a higher level of risk and eroding the credibility of deterrence. The severity of reductions needed to achieve this path would require the active cooperation of DoD to ensure that serious disruptions were minimized. The reductions needed to achieve a multi-year freeze go beyond the scope of alternatives that can be reviewed in this chapter.

EFFECT OF NEW ACCRUAL ACCOUNTING PROCEDURES

Beginning with the 1985 budget, military manpower costs will reflect "accrual accounting" procedures designed to include the cost of retirement benefits that have to be paid in the future to those individuals expected to remain in and retire from service. Under those procedures, the accrual costs of future retirement liabilities, rather than actual payments to retirees, appear in the defense budget. (Calculating an accrual cost for retirement is analogous to calculating how much must be invested now in an Individual Retirement Account to receive specified income payments in the future.) Accrual accounting is designed to show the costs of future retirement in today's defense budget, so that retirement costs will be considered in current decisions even though the actual expenditures will not be made for many years.

Under accrual accounting, a proposal that cuts future manpower or retirement benefits would show up immediately as a large reduction in budget authority and outlays in the defense budget and budget authority in the total federal budget. These categories of costs all reflect future retirement costs. Because the accrual charge is offset elsewhere in the budget (subfunction 951), however, outlays in the federal budget as a whole still reflect only payments to current retirees. Since payments to retirees fall only gradually under most proposals affecting military manpower, over the next five years outlay savings in the total federal budget are often much smaller than those in the defense budget. As a result, those options below involving changes in manpower or manpower policies will show different outlay costs or savings in the Defense Department and in the total federal budget. (For example, see Option II-13 below on page 41.) For a more detailed discussion of accrual accounting, see Congressional Budget Office, Accrual Accounting for Military Retirement: Alternative Approaches (July 1983) and An Analysis of the President's Budgetary Proposals for Fiscal Year 1985 (forthcoming).

II-1. CANCEL THE ARMY HELICOPTER IMPROVEMENT PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	300	300	500	600	500	2,200
Outlays	40	150	300	400	500	1,400

The Army Helicopter Improvement Program (AHIP) is an interim program intended to provide a more capable scout helicopter by the mid-1980s by modifying the existing OH-58 helicopter. The Army has long-term plans to procure a new light helicopter (the LHX) to satisfy in part the scout mission by the early 1990s. Cutting out the AHIP and waiting instead for the new helicopter could save an estimated $2.2 billion over the next five years.

Scout helicopters carry no weapons; their primary mission is to identify and designate targets for both attack helicopters and artillery. The AHIP will improve the identification and designation of targets at nighttime (by using infrared sensors and laser range finders) and will improve the operational capability of the helicopter in the hot climate of Southwest Asia (by upgrading the engine and transmission and by adding a four-blade main rotor).

The AHIP program would improve 442 scout helicopters during 1985-1989 and modify a total of 578 scout helicopters by 1990. In the meantime, the Army is developing a new fleet of helicopters to perform the scout-observation mission and complement the new Apache attack helicopter. This new fleet of scout helicopters is planned for production in the early 1990s.

Cancellation of AHIP would require the Army to rely upon the current OH-58 scout helicopter until the new fleet of scout helicopters is deployed in the early 1990s. Some of the target identification and designation mission could be provided by the Ground Laser Locator Designator (designed for the artillery), which is now in production. A small portion of the savings might be devoted to minor "safety-of-flight" modifications, though those costs would reduce the savings shown above.

II-2. CANCEL THE LANTIRN PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	300	500	500	700	700	2,800
Outlays	80	200	350	500	600	1,700

Low Altitude Navigation and Targeting Infra-Red System for Night (LANTIRN) is designed to aid the pilot of a single-seat aircraft in searching out and destroying surface targets while flying at low altitudes in poor visibility. The system identifies potential targets based on infrared radiation and controls the flight of an air-to-surface missile that homes-in on the radiation source. LANTIRN has been criticized within DoD as not likely to be effective for this primary mission. Terminating the program would save an estimated $2.8 billion over the next five years.

Several U.S. aircraft are scheduled to use the LANTIRN system: the F-16, the A-10, and an improved version of either the F-16 or the F-15. The Air Force plans to procure almost 700 LANTIRN units, of which 400 are scheduled to be purchased by 1989. DoD argues that LANTIRN would be necessary to counter the large threat from enemy armored vehicles in the event of a European conflict.

The LANTIRN system has been controversial since its development in 1979. A recent report by the Defense Science Board criticized the automatic target recognition subsystem--the heart of LANTIRN--and stated that this capability is unlikely to be achieved soon. At the same time, LANTIRN's cost has almost doubled in three years, from $3.0 million per system in 1981 to $5.8 million in 1983. During the fiscal year 1984 budget debate, the House Armed Services Committee cancelled the system, arguing that it was too expensive for the capabilities it was likely to provide. Though most of the funds were put back in conference, the fiscal year 1984 Authorization Act Conference Report instructed the Air Force to investigate alternatives to the system in case of subsequent cancellation.

If the Congress chose to cancel LANTIRN, it could spend some of the savings to purchase other infrared systems to meet navigation needs, but forgo the problematic automatic target recognition. Those costs would lower the savings shown above.

II-3. AMEND THE AIRLIFT EXPANSION PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Cancel C-17 Program						
Budget Authority	100	400	700	3,100	3,500	7,800
Outlays	80	300	400	1,300	2,200	4,300
Cancel C-5 Program						
Budget Authority	2,600	3,000	2,700	--	--	8,200
Outlays	300	1,500	2,300	2,200	1,100	7,400

The Air Force is currently committed to build two types of large military cargo aircraft to supplement today's fleet--an updated version of the existing C-5 and the newly developed C-17, which will not be ready for production until the late 1980s. In response to the 1979 Persian Gulf crisis, President Carter directed the Air Force to develop a new transport aircraft, which became the C-17. Skeptical of certain program details, the Congress required DoD to study mobility requirements before proceeding with the program. DoD responded with the so-called Congressionally Mandated Mobility Study (CMMS), which concluded that a substantial shortfall in airlift capacity existed, primarily for "outsize" cargo--that is, the heavy, bulky cargo typical of Army equipment, such as tanks.

Though the two planes were orignally proposed as contenders, in 1982 the current administration decided to build both, beginning with 50 C-5s, since they could be fielded relatively quickly, and following with an unspecified number of C-17 in the later part of the 1980s. Since the two programs are essentially redundant, the Congress could choose to proceed only with one. Because the Congress has already appropriated funds to launch the updated C-5 program, it would be most logical to cancel the C-17. Such a course would offer initial five-year savings of $7.8 billion since large numbers of the C-17 will not be ready until later in the decade. If large near-term reductions were desired especially in terms of outlays, the C-5 program could be cancelled and the C-17 program, whose costs would occur somewhat later, could be approved, producing five-year savings of $8.2 billion, compared to Administration plans. This option would only postpone costs until the 1990s, however.

Terminating the C-17 but continuing the C-5 procurement has some advantages. The acquisition of 50 additional C-5s would substantially meet

the airlift shortfall identified in the CMMS. Although some shortfall might still exist, it would be much less expensive to buy more C-5s than to develop a new aircraft like the C-17. To meet any remaining shortfall, Congress could direct DoD to continue investigating ways to reduce the cargo requirements. For example, the Army is reviewing its operations plans in order to reduce cargo demands, and is examining selective prepositioning of certain equipment. Further, DoD is studying less expensive ways to meet any remaining shortfalls, such as the early deployment of ships.

Proponents of the C-17 note, however, that it could be used as a short-range tactical transport in combat areas where airfields are relatively unimproved. The Air Force does not believe the C-5 can routinely operate in these conditions and the C-17 is needed for this mission. Therefore, as an alternative, the Congress could revise the Administration's mobility modernization effort, terminate further production of the C-5, and proceed directly with plans to procure the C-17 instead. Such a course would produce somewhat larger savings in budget authority but substantially greater outlay savings, although it would extend the period of airlift shortfall and simply delay costs to the outyears.

Under this option, the C-17 could eventually provide the long-range and outsized cargo lift capability of the C-5 and also would contribute to future short-range or tactical airlift needs. The six C-5 aircraft procured in fiscal years 1983 and 1984 will continue to contribute to mobility improvements and can be used immediately by the airlift forces since a logistics support base already exists for the C-5.

Terminating the C-5 program would, however, reduce the strategic airlift capability currently planned over the next five years. This could be important if the United States were to become engaged in a conflict with the Soviet Union in Europe or Southwest Asia and needed to transport a large number of combat forces quickly. In the long term, however, the C-17 would provide the equivalent strategic mobility of the C-5. Another consideration in cancelling the C-5 is the substantial regional economic effects since many workers would be unemployed. Also, its termination could well entail cancellation charges which might reduce the above savings.

II-4. CANCEL OR REDUCE PROCUREMENT OF THE F-15

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Freeze Annual Procurement at 36						
Budget Authority	600	1,100	1,600	2,800	2,600	8,700
Outlays	70	400	800	1,400	2,100	4,800
Cancel the F-15						
Budget Authority	1,200	2,100	3,300	4,600	4,400	15,700
Outlays	100	800	1,600	2,700	3,700	8,900

The F-15 is the Air Force's premier fighter, capable of operating during day or night and in inclement weather. Its long-range radar and medium-range missile enable it to preempt detecting and attacking enemy aircraft. It is also such an expensive plane, that the Air Force had to develop the less capable, cheaper F-16 to fulfill its total force requirements. In each of the last three years, the Congress rejected DoD requests to increase purchases of F-15s. In 1984, for example, the Congress cut F-15 procurement from the requested 48 to 36, directing DoD to buy more F-16s instead. The Congress expressly noted through provisions for long-lead funding that it intends to limit further F-15 purchases to 36 per year. DoD is proposing to buy 48 in 1985, increasing to 96 per year by 1988.

The Congress could freeze F-15 production at 36 planes annually. Relative to Administration plans, this would save $8.7 billion over the next five years. This option would not foreclose Air Force plans to increase its tactical force from its current 36 wings to 40 wings by 1989. (A wing consists of 72 combat aircraft, but requires an additional 27 aircraft for training and maintenance purposes.) Increasing the force depends on procurement of more F-15s and F-16s in part to replace older F-4 aircraft, most of which will reach their usual service life of 20 years by the late 1980s. If the F-4s were retained until they are 25 years old, F-15 production could be frozen at 36, and the Air Force could still meet its force goals.

Should greater savings be needed, the Congress could limit purchases of F-15s to 24 and 12 in 1985 and 1986 respectively, terminating purchases in 1987, saving an estimated $15.7 billion. Cancelling the F-15 without offsetting increases in F-16 purchases would prohibit expanding the number of Air Force wings unless even larger numbers of F-4s are kept until at least

25 years of age. Cancellation would also reduce wartime capability to expand aircraft production and would foreclose the option of procuring an improved version of the F-15 that the Air Force is considering for its ground attack mission.

The effects of freezing or cancelling F-15 procurement could, of course, be partially offset by increasing production of F-16s. Purchasing more F-16s to replace F-15s would produce some savings, although they would be substantially smaller. Since the F-16 is less capable than the F-15, the force would be less effective than planned. Equipping the F-16 with the Advanced Medium-Range Air-to-Air Missile (AMRAAM) by 1987 could give that fighter much of the F-15's interceptor capability, however.

The Congress could also offset the capability effects of cutting the number of F-15s by directing some of the savings toward accelerating development of the Advanced Technology Fighter (ATF), the Air Force's long-term modernization approach. Under current plans the ATF will not be fielded until 1995, but accelerated funding could potentially advance the date.

II-5. TERMINATE PRODUCTION OF THE A-6 BOMBER

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	250	--	--	--	--	250
Outlays	40	100	70	20	9	239

The A-6 bomber is the Navy's most sophisticated attack aircraft, designed to operate at night and in poor weather against ship and land targets. It is a relatively old aircraft design, having first been deployed in 1963, though it has been updated repeatedly. The A-6 has been the subject of a lively debate during the last year. The Secretary of the Navy is seeking to upgrade it, to make it the principal medium bomber of the naval task force well into the next century. The Defense Resources Board--the DoD "Board of Directors"--voiced doubts about the wisdom of that plan and suspended procurement of the A-6 after this year. Complicating this picture, the Senate Armed Services Committee last year recommended suspension of the A-6 because of their concern that the Navy has too many types of aircraft in production, resulting in slow production rates, high unit costs and delayed modernization. (The Committee later receded to the House's plans to continue production at six aircraft a year.)

The Congress could choose to cancel further purchases of the A-6, saving $250 million in 1985. Though the President's budget contains no funds for A-6 procurement beyond 1985, informal reports indicate that the Navy intends to press for A-6 purchases beyond 1985. At the 1985 production rate, termination in 1985 might save an estimated $1.7 billion beyond that shown above, though the Navy could be expected to program those savings toward other activities or purchases without necessarily lowering aggregate spending requests.

Termination of the A-6 could jeopardize its prospects as the next generation medium attack bomber. (Continued production of the A-6 could lower startup costs for an updated A-6.) In addition, since the Grumman Aerospace Corporation manufactures both the A-6 and the F-14, if production of both aircraft were suspended (see Option II-6) severe economic problems might result on New York's Long Island where both aircraft are produced. Finally, the Navy has argued that the existence of the A-6 production line has allowed them to achieve a competitive climate and hold down production costs for the F/A-18 fighter attack aircraft.

II-6. SUSPEND PRODUCTION OF F-14, PROCEED WITH UPGRADE

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	700	1,300	800	700	300	3,800
Outlays	90	500	900	900	700	3,000

The F-14 is the Navy's most capable and expensive fighter/interceptor. It was designed to defend the aircraft carrier and its escorts at long range, engaging as many as six attacking aircraft at one time. The F-14 entered service in 1972. Though it represents a somewhat dated design, the Navy intends to update the F-14 to make it the premier interceptor for the remainder of the century. This updated "D" model would feature improved engines and combat electronics. The Navy expects to place its first orders in 1988. In the interim the Navy plans to continue purchases of the existing model F-14, buying 24 in 1985 and 1986 and 12 in 1987.

The Congress could choose to terminate further purchases of the older design F-14 and await the development of the improved D model. This alternative was apparently under consideration earlier in the year by the Navy, but was subsequently dropped in favor of interim purchases. Specifically, this alternative would buy 12 F-14s in 1985 and suspend further purchases until the first 12 D model aircraft can be ordered in 1989. This action would save $3.8 billion relative to Administration plans.

Were the Congress to direct such action, the Navy would have a break in production capabilities for a period of three years. (CBO estimates exclude termination costs but include re-start production costs, which have been deducted from the above savings.) Further, suspension could jeopardize the Navy's plan to outfit the 14th carrier airwing with F-14s in 1987, necessitating interim use of F-18s or older F-4s until the new D model aircraft are delivered.

II-7. LIMIT PRODUCTION INCREASES OF THE MX MISSILE

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	1,600	1,600	1,500	1,600	-1,000	5,300
Outlays	300	900	1,300	1,400	1,000	4,900

The MX missile is a new-generation land-based intercontinental ballistic missile (ICBM), which the Congress first authorized for production last year after ten years of development by the Air Force. Capable of delivering 10 high-yield nuclear warheads and weighing nearly 100 tons, the MX will be the largest, most accurate ballistic missile in the U.S. arsenal.

Debate on the MX program has been extraordinarily contentious. After many unsuccessful proposals for deployment, the Administration finally decided to buy 223 MX missiles, enough for operational testing and backup and to deploy 100 missiles in existing missile silos. The program cost would exceed $34 billion. The Congress endorsed production of 21 MX missiles in 1984, and Administration plans call for increasing production to 40 in 1985 and 48 in 1986 and beyond.

Following the lead of the President's select commission to study the MX (the Scowcroft Commission), the Administration no longer justifies the MX primarily as a survivable addition to the strategic nuclear force, since the Soviets could theoretically destroy most of the missiles during a first-strike attack. Instead, the MX serves as a demonstration of U.S. willingness to proceed with force modernization and an inducement to the Soviet Union to negotiate in good faith for arms control.

The Congress could choose to limit annual MX missile production to the 1984 rate of 21. This course would continue MX production, demonstrating U.S. commitment to strategic modernization, while allowing the Congress to observe developments on arms control before deploying all 100 missiles. Should full deployment be desired, limiting production now would extend by a few years the conclusion of the deployment program. Although limiting production rates would increase unit costs, it would provide savings of $5.3 billion in 1985-1989 compared to the Administration's plan.

II-8. LIMIT PRODUCTION OF THE M2 BRADLEY FIGHTING VEHICLE

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	200	400	500	500	400	2,000
Outlays	10	100	300	400	500	1,300

The Army's M2 Bradley fighting vehicle is designed to accompany and keep pace with the M1 Abrams tank on the battlefield. The M2 carries both the TOW antitank missile and a new 25-millimeter automatic cannon. The M2 would be a substantial improvement over the old M113, which provided armored protection for infantry squads but had little offensive striking power of its own.

The M2 has been criticized in recent years, however: for its great expense ($1.5 million each in 1985 dollars, with Army plans to buy 6,882 units by the end of 1990); on technical grounds (some critics charge that its aluminum armor "burns" when hit by modern munitions); and for its poor amphibious capabilities. Nonetheless, it is assessed to be superior to any fighting vehicle available to Warsaw Pact forces.

During the past three years, the vehicle has been produced at a rate of 600 vehicles per year, a rate consistent with the current plant capacity operating one shift, eight hours per day, five days per week. The Department of Defense proposes to increase production to 710 in 1985 and to a sustained rate of 900 vehicles per year in 1986.

The Congress could choose to hold production to the current efficient rate of 600 vehicles annually rather than increase production by approximately 50 percent within the next two years. Although some units would not receive the fighting vehicle as quickly as under the Administration's plans, the forward-deployed units would not be significantly affected if the current rate of production were maintained. This option would save $2 billion over the next five years, compared to the Administration's plan.

II-9. REDUCE CONSTRUCTION OF NEW SUBMARINES AND LSDs WHILE EXTENDING THE SERVICE LIFE OF EXISTING SHIPS

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	1,100	1,100	1,300	1,400	1,500	6,500
Outlays	70	200	400	700	900	2,400

Public debate on naval procurement emphasizes new ship construction, but equally important are service life extensions and combat system modernization for existing ships. Though Navy planners prefer to build new ships, the expedient of making older ships last longer has often been used in the past and figures prominently in current plans for a "600-ship Navy." Selectively extending the service lives of some submarines and amphibious landing ships (LSDs) could permit shipbuilding budget reductions in excess of $1 billion per year without significant impact on ship force levels. Obviously, such a course would affect the pace of fleet modernization.

Between 1984 and 1989, the Navy plans to retire 16 attack submarines (12 nuclear-powered and 4 diesel-electric), and build 23 SSN-688 class attack submarines. The average cost of each new submarine will be about $750 million (in fiscal year 1985 dollars). Holding procurement of SSNs at the 1984 level of three per year, rather than four per year, and extending the service life of an offsetting number of the older submarines would save $4.4 billion in procurement over the five-year period.

Similarly, the Navy plans to retire the eight Thomaston-class LSDs between 1983 and 1990, and to replace them with new LSDs, programmed at the rate of two per year. Slowing construction of new LSDs to one per year, offset by extending the operating life of at least some of the Thomaston-class LSDs, would result in savings of $2.1 billion over five years.

Any reduction in the shipbuilding program would diminish the naval force modernization, and would be offset only partially by extending the service life of older ships. The older submarines and LSDs mentioned above will have been in service about 30 years at their currently scheduled retirements, a venerable age by normal Navy standards. The older submarines, though less capable than the new SSN-688s, are, nevertheless, formidable warships still capable of performing a broad range of useful missions. The older LSDs, being relatively uncomplicted naval ships, suffer only from age, not technological obsolescence.

II-10. DEFER DEVELOPMENT OF THE DDG-51 AND ACCELERATE PROCUREMENT OF CG-47 CLASS SHIPS

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	200	-1,100	2,000	2,500	2,600	6,200
Outlays	10	-40	-10	300	700	1,000

The Navy is requesting funds in 1985 to build the first ship in a new class of destroyers, the DDG-51. Intended as a less costly complement to the expensive AEGIS CG-47 cruiser, the DDG-51 will be, nevertheless, a very expensive ship but less capable than the CG-47. The Congress could choose to defer further development of the DDG-51, increase purchases of the more capable CG-47 in the interim, and launch efforts to develop a more affordable system for the future. Such a course would save an estimated $6.2 billion over the next five years compared with the Administration's plans, but would delay a program to which the Navy has assigned high priority.

The first DDG-51 is projected to cost $1.3 billion, a substantial sum in its own right, but the ultimate budgetary implications of the DDG-51 program are far more substantial. Although the Navy hopes that the average cost for subsequent DDG-51s will be about $780 million (in 1985 constant dollars), meeting that goal is not assured. Navy cost estimates for the DDG-51 assume production efficiencies never achieved for the CG-47 or other recent warship programs. Indeed, if the Navy could achieve the same efficiency for the CG-47 program as assumed for the DDG-51, it could buy an equal number of the more capable CG-47s for the same cost as the scheduled mixture of CGs and DDGs.

Apart from cost, other questions regarding the DDG-51 concern its suitability for the roles surface combatants are likely to fill in future naval combat. The DDG-51, like the CG-47, emphasizes high-power electromagnetic and acoustic sensors for a classic screen defense of carrier battle groups. New long-range antiship weapons and surveillance capabilities are forcing new naval tactics that emphasize widely dispersed formations, strict electromagnetic and acoustic emissions control, cover and deception, and exploitation of targeting information from a multiplicity of off-board sources. The question arises whether a ship designed for an inner screen role, that features easily detected high-powered sensors and carries no helicopters, is suited to this dispersed and silent combat environment.

In addition, new technical developments are emerging that could have important implications for future warship design, capability, and costs. These include basic changes in design practice such as the Ship System Engineering Standards (SSES) technique, distributed combat system architecture, and modular component design that would permit ships to be much more rapidly modified in response to changing threats or improved technology. Most of these technologies were not sufficiently mature to be fully incorporated into DDG-51.

The Congress, therefore, could choose to defer authorization of DDG-51, while increasing procurement of the CG-47 class, and direct the Navy to accelerate development of a new generation of smaller, lighter, modular combat systems that will be suited to an accelerating technological pace and the future combat environment. Specifically, the Congress could choose to defer authorization of DDG-51 indefinitely and increase production of CG-47 class ships from current levels (three ships for three years, two ships for two years) to four per year, resulting in seven fewer total ships authorized over the next five years (20 CGs compared with 13 CGs and 14 DDGs). This could lead to more efficient production of the CG-47 class ships, especially now that annual ship orders will be split between two producers. Net savings over the next five years would equal $6.2 billion. More significant savings could be realized in later years if a less expensive DDG could be designed.

Adoption of this option, however, would cause the delay or cancellation of a program that has been in gestation for five years and to which the Navy has consistently assigned a high priority. The Navy has stated repeatedly that the DDG-51 is the ship that fills its current needs. The Navy believes that it is necessary to begin production of the DDG-51 class now in order to achieve deliveries as older destroyers are retired in the 1990s.

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II-11. REDUCE ONE ARMY DIVISION TO CADRE STATUS

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	50	200	300	300	300	1,100
Outlays	40	100	200	200	200	700
Savings in Defense Budget						
Budget Authority	50	200	300	300	300	1,100
Outlays	50	200	300	300	300	1,100

Faced with less rapid growth in future budgets, the Army has indicated that modernization of the force should remain the highest priority, even at the expense of size of the force. If the Congress decided that the defense budget cannot sustain both the current pace of Army modernization and present force structure, it could choose to reduce further the size of current forces. Some reductions in the Army's active force have already been made by greater use of reserve forces. The Congress could direct the Army to reduce the low-priority 7th Infantry Division at Fort Ord, California, to a cadre status of about 5,000 active-duty soldiers, a reduction of approximately 8,500 people. That level would ensure the continuation of division planning and managerial functions and the maintenance of equipment. The alternative was under consideration by the Department of Defense in September 1981. Unlike plans at that time, however, this alternative would cut the size of the Army, since the Army plans no manpower increases over the next five years. This action could save about $1.1 billion over the next five years, compared to Administration plans. Individual Ready Reserves--who do not drill in peacetime--could fill division positions should mobilization occur, a feasible alternative since the 7th Infantry Division would be one of the later deploying units in the event of war.

Under cadre status, the 7th Infantry Division would deploy more slowly than it could now. This division was selected, however, because it already has lower mobilization status. Indeed, some reserve component elements have higher mobilization and deployment priorities than this division. Nonetheless this action would reduce the immediate combat effectiveness of the 7th Infantry Division. Under rapid mobilization, this force reduction might render the United States slightly less able to meet all of its current deployment objectives.

The Army is contemplating a significant redesign of its light divisions, with the 7th Infantry Division a candidate for reorganization. This option would preclude those plans for the 7th but not for the other six appropriate light active and reserve divisions in the Army. (The reason for and significance of the two savings projections above is explained in Editor's Note on page 24.)

II-12. SLOW TACTICAL AIR FORCE INCREASES

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	100	400	500	500	600	2,100
Outlays	70	230	370	440	500	1,600
Savings in Defense Budget						
Budget Authority	100	400	500	500	600	2,100
Outlays	80	260	400	470	540	1,700

Three years ago, the Administration announced its intention of increasing the Air Force tactical fighter force structure to 40 air wings by 1986, with a further increase to 44 wings by the early 1990s. (A wing consists of 72 combat aircraft with 27 backup aircraft used for training and maintenance purposes.) The increases were judged necessary to meet expanded global requirements. Despite the need for more wings, the pressure to finance higher-priority programs has led the Air Force to postpone these increases. The Air Force currently plans to field 40 wings by 1989, while the ultimate goal of 44 wings has become somewhat uncertain.

If the Congress chose to make further savings it could stretch out this proposed buildup for two additional years, saving $2.1 billion over the next five years, compared to the Administration's plan. (The reason for and significance of the two savings projections above is explained in Editor's Note on page 24.) Slowing the force increases could also produce near-term procurement savings as the smaller wing structure would require fewer aircraft. The proposal to limit or cancel production of the F-15 (see Option II-4 above) illustrates potential savings.

The Air Force believes the increasing quality and quantity of Soviet aircraft are posing a growing threat. Delaying the expansion of tactical fighter wings would prolong for two years the risk period. Nonetheless, these are risks that even the Air Force has judged acceptable since it has already slowed its own build-up plans.

II-13. REDUCE COLAs FOR WORKING-AGE MILITARY RETIREES

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	3,730	4,030	4,330	4,640	4,970	21,700
Outlays	-120	140	640	960	1,270	2,880
Savings in Defense Budget						
Budget Authority	3,730	4,030	4,330	4,640	4,970	21,700
Outlays	3,730	4,030	4,330	4,640	4,970	21,700

The military retirement system provides benefits for approximately 1.4 million persons at a cost of about $16.6 billion in 1984. Most military retirees are relatively young when they begin drawing their benefits; for example, in 1983 the average retirement age for nondisability active-duty persons was 43 years. In 1982, the Congress decided to provide half the regular cost-of-living adjustment (COLA)--as measured by the CPI--to retirees under age 62. This "half-COLA" applied only for fiscal years 1983, 1984, and 1985. The provision also applied only when half the normal COLA exceeded a minimum raise specified in the law. Making this half-COLA provision permanent, and removing the requirement for a minimum raise, would save an estimated $21.7 billion over the next five years in budget authority; outlay savings would equal $21.7 billion in the defense budget but only $2.9 billion in the total federal budget. (The difference in savings between defense and the total federal budget is discussed below.) All savings are relative to current law at the time of publication.

Most nondisability retirees work in second careers and thus, in the arguments of proponents of this option, need less inflation protection than their older counterparts, who are no longer in the labor force. Indeed, lower annuities for military retirees in their working years have been recommended by most of the nine major studies of the military retirement system completed since 1969.

Opponents of such a change argue that this provision ties an important part of military compensation to future inflation, which is highly uncertain.

This valid concern could be minimized if retirees were granted full cost-of-living protection for annual price increases above some high level---such as 10 percent. Opponents also argue that any reduction of future retirement benefits would induce premature retirements and so reduce the size of the career force. Indeed, CBO estimates that this plan would lower the career force (defined as those with four or more years of service) by about 4 percent. If necessary, this modest reduction could be offset by other incentives such as reenlistment bonuses in those skills where reduced retention was undesirable. This possible cost increase was not included in the above estimate but would not offset more than a small part of the total savings.

Savings in the defense budget would be larger than those in the federal budget as a whole over the next five years because of the new "accrual" accounting procedures enacted last year. Under those procedures, the accrual costs of future retirement liabilities, rather than actual payments to retirees, appear as budget authority and outlays in the defense budget and as budget authority in the total federal budget. (Calculating accrual cost for retirement is analogous to calculating how much must be invested now in an Individual Retirement Account to receive specified income payments in the future.) Accrual accounting is designed to show the costs of future retirement in today's defense budget, so that retirement costs will be considered in decisions made today even though the actual expenditures will not occur for many years.

Under accrual accounting, the half-COLA proposal--which would cause future retirement costs to drop sharply--would cause a large reduction in defense and total federal budget authority and in defense outlays. These reductions in budget authority correspond to the savings in retired pay that the government eventually would realize under the half-COLA proposal. But the outlays in the defense budget for the accrual costs are cancelled out elsewhere in the federal budget, so federal outlays continue to reflect actual payments to retirees. Since payments to retirees fall only gradually, total federal outlay savings over the next five years would be smaller than reductions in budget authority. Indeed, outlays in the federal budget actually increase in the first year because this option would cause changes in the overall composition of the military forces, as noted above, and thus would lead to changes in related military personnel costs. The savings in retirement outlays, when combined with these associated changes in personnel costs (pay and allowances, recruiting, and training), produce net reductions in federal outlays after an initial increase in cost due primarily to training costs for new personnel.

II-14. LIMIT THE MILITARY PAY RAISE

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	900	1,300	1,400	1,500	1,600	6,700
Outlays	600	900	1,000	1,000	1,100	4,600
Savings in Defense Budget						
Budget Authority	900	1,300	1,400	1,500	1,600	6,700
Outlays	900	1,300	1,400	1,500	1,600	6,700

The Administration has proposed a 5.5 percent pay raise for all military personnel, effective January 1, 1985. This raise is apparently designed to match the average raise given to private-sector civilian workers during the previous year. Military recruiting and retention, however, have been excellent for the past two years and thus it may be possible to limit the pay raise to 3.5 percent in January 1985 while meeting minimum recruiting goals and allowing further increases in the number of career personnel. A 3.5 percent increase would equal the same raise proposed by the Administration for federal civilian employees. This action would save substantial sums. In 1985, the savings would amount to $900 million and, over the five-year period 1985-1989, savings would total $6.7 billion, compared to Administration plans. For an explanation of the difference in the savings estimates see Editor's Note, p. 24.

Limiting the pay raise to 3.5 percent would, of course impair recruiting, but might not jeopardize personnel goals. CBO estimates that, with a 3.5 percent raise, the Army in 1985 would meet its numerical requirements for recruits while exceeding the minimum goals set by law for male recruits without prior military service who hold high school diplomas. Minimum recruiting goals in the other services would also be met.

Career retention would also be less with a 3.5 percent raise. CBO estimates that 3,000 fewer enlisted career personnel (that is, those with four or more years of service) would be retained in 1985. But the number of career personnel would continue to rise over today's level.

This limit on pay raises could cause some shortages in 1985 in skills where recruiting or retention are particularly difficult. Such spot shortages could be offset at modest cost by increasing enlistment or reenlistment bonuses.

While widespread near-term problems are unlikely, pay limits could lower recruiting and retention as the economy recovers, especially in the Air Force and the Navy, which plan substantial manpower increases over the next five years. If problems develop, the Congress might have to provide catch-up raises in later years, thus reducing long-run savings.

II-15. IMPOSE OUTPATIENT FEE AT MILITARY MEDICAL FACILITIES

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	165	170	170	170	170	845
Outlays	165	170	170	170	170	845

The Department of Defense bears most of the costs of military medical care, including that for retirees and dependents. DoD could save $845 million in 1985-1989 by charging retirees and dependents $10 for each outpatient visit (but no more than $100 a person annually).

Each visit with a military physician--for which DoD spends about $49--is free to retirees and dependents. A $10 fee per visit would raise revenues of $840 million over the five-year period. Though administrative costs would offset a small part of this revenue, reductions in outpatient visits could allow for even further, sizable savings; studies suggest that people use fewer services if they have to pay. Nor should medical care be significantly affected; studies suggest that, at ages and income levels typical of DoD personnel, persons will seek needed care even with this modest outpatient fee. Moreover, a charge would improve equity between people who live near inexpensive military facilities and those whose location forces them to use civilian facilities. DoD pays only a part of costs at civilian facilities.

Opponents of charging a $10 fee argue that medical care is an important part of military compensation; thus the fee would be seen as an erosion of benefits and would hurt recruitment and, especially, retention. The relatively low fees should lessen these problems, however. Several major studies--including the President's Private Sector Survey on Cost Control--have recommended a fee, and some Congressional committees have endorsed a similar fee.

II-16. RESTORE PREVIOUS ENLISTED/OFFICER RATIOS

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	90	300	600	800	900	2,700
Outlays	60	200	400	600	600	1,900
Savings in Defense Budget						
Budget Authority	90	300	600	800	900	2,700
Outlays	90	300	600	800	900	2,700

The ratios of enlisted personnel to officers in the armed forces could be increased, possibly with little loss of military effectiveness. Since its post-Vietnam peak in 1977, the ratio has declined from 6.5 enlisted persons for every officer to about 6 per officer in 1983. (Since 1964, the ratio has declined from 6.8 to 6.) The sharpest decline has occurred in the Army; its ratio has fallen from 7 enlisted per officer to 6.3 per officer. Some military missions (such as training) require fewer enlisted per officer than other missions (such as general purpose combat forces). But the decline in the ratio is not explained by shifts in major military missions.

Increases in technical complexity may, of course, justify having more officers relative to enlisted personnel. Each of the services plans the mix of officers and enlisted personnel at a highly detailed level. Nonetheless, the persistent tendency of the ratio to decline may suggest the need to impose aggregate limits. Such limits would also be consistent with announced Administration efforts to reduce the number of federal civilian personnel at middle and senior levels.

The Congress could require that the services recruit fewer officers while leaving their enlisted recruiting plans untouched. If, over the next three years, officer strengths were reduced by 15,000, then by 1987 the ratio would be about 6.25 enlisted per officer; this would reverse about half the decline that occurred between 1977 and 1983. This policy would reduce manpower levels moderately and cut costs in the federal budget by about $90 million in 1985 and by a total of $2.7 billion over the next five years, compared to the Administration's plans. (For an explanation of the different savings projections noted above, see Editor's Note on p. 24.)

Savings would be significantly smaller, of course, if the Congress decided to maintain total planned manning in the military and to reduce the ratio by substituting enlisted personnel or lower-ranking warrant officers for officer personnel.

II-17. REDUCE NAVY ACTIVE-DUTY MANPOWER ASSIGNED TO SHORE DUTY

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
	Savings in Total Federal Budget					
Budget Authority	40	100	200	300	300	1,000
Outlays	20	80	100	200	200	600
	Savings in Defense Budget					
Budget Authority	40	100	200	300	300	1,000
Outlays	40	100	200	300	300	1,000

The Navy projects a need for 40,000 more active-duty personnel over the next five years to staff new ships and to maintain desired peacetime operating rates. This increase could be partially avoided if active-duty personnel could be induced to remain longer in sea-going jobs rather than rotate to shore duty. Specifically, raising sea pay--a special pay given to those assigned to shipboard duty-- to increase time spent at sea from an average to 60 to 65 percent of total active-duty time would save $1 billion over the next five years, even after allowing for the costs of higher sea pay. (For an explanation of the different savings projections noted above, see Editor's Note on P. 24.)

Navy manpower is divided into three groups: active duty, reserve, and civilians. During peacetime, overseas deployments are manned by active-duty personnel while most reserve and civilian personnel are assigned to shore jobs, as are over 200,000 active-duty personnel. Some of these shore jobs provide "rotation billets" for sailors finishing arduous sea tours, thus helping improve morale and promoting adequate retention among career personnel. Inducing Navy personnel to volunteer for longer tours at sea would reduce rotation billets and so would require fewer active-duty personnel without decreasing sea-going commitments or harming retention of career personnel. Currently, the Navy has two shore billets for every three sea billets (that is, on average, each enlisted member spends 60 percent of his time on sea duty). Increasing that average percentage to 65 percent would eventually save 14,500 enlisted shore billets. Studies and recent experience suggest that higher sea pay would--at a cost of $21 million in 1985 rising to $82 million in 1987 and beyond--induce enough extra

volunteers for shipboard tours to achieve the 65 percent goal. (These estimates assume that the shift to more sea duty time is implemented over the three-year period 1985 to 1987, and that sea pay is increased at the same annual rate as basic pay and allowances.) The reduction in shore billets would save money even when offset by the costs of higher sea pay. Moreover, productivity might increase, since sailors would be working more in shipboard jobs that use their primary training.

Cutting 14,500 military positions would involve a 3 percent reduction in the planned growth of military and civilian personnel available for work at shore facilities. This should not, however, prevent needed work from being done. Even after the cut, the total available shore positions would still increase by 1.5 percent, compared with an increase of 12 percent in numbers of ships. Shore facilities should not need an increase proportional to the increase in numbers of ships, since there is a substantial "fixed" component to shore facility workloads.

II-18. LIMIT REAL GROWTH INCREASES IN DoD RESEARCH AND DEVELOPMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	2,400	2,600	2,700	3,100	3,300	14,100
Outlays	1,300	2,300	2,600	2,800	3,100	12,100

In 1985, the Administration is requesting $34 billion for Research, Development, Test, and Evaluation (RDT&E) for DoD. RDT&E funding pays for a wide range of activities: primary research such as high energy physics or microbiology, applied research such as ceramic engineering or construction engineering, engineering development to put weapons systems into production, testing programs for potential weapons or experimental designs, and so forth. RDT&E funds operate numerous government laboratories, and pay for research in universities and private laboratories as well as by contractors.

The sufficiency of RDT&E funding cannot be measured, nor can the potential compromises necessitated by cuts. Much of the purpose of RDT&E funding is to explore a wide range of ideas; only thorough research and testing will separate the fruitful from the fruitless prospects. Modest increases in funding ensure that some projects of lower priority are undertaken. Modest decreases probably mean cuts in marginal program areas or areas where some delay is acceptable.

During the past two years, the Congress has trimmed Administration RDT&E requests by approximately 7 percent annually. Some of the reductions were targeted to specific programs where the Congress judged reductions were appropriate or acceptable. In other instances, reductions were undistributed or were presumed to result from improved efficiency on the part of laboratories and contractors. The Congress could again reduce this year's funding request by 7 percent, resulting in five-year savings of $14.1 billion compared to the Administration's program. This would still permit over 8 percent real increase in RDT&E in 1985. This would also leave RDT&E at 10.4 percent of the DoD budget, a level similar to the percentage it received in 1984.

As noted above, it is not possible to delineate the risks that might come from limiting increases in this account for one year. Presumably the

Department would continue to fund those efforts that offer the greatest promise, and postpone those efforts judged to have somewhat less potential. In any event, the funding limitations would merely postpone by one year the start of selected programs.

II-19. LIMIT REAL GROWTH IN "SUPPORTING" PROCUREMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	3,000	3,300	3,600	3,900	4,300	18,100
Outlays	200	1,300	2,400	3,100	3,600	10,600

Highly visible procurement programs--such as the B-1 bomber, the MX missile, aircraft carriers, and new tanks--dominate the public debate over the defense budget. Such major acquisitions, however, routinely require approximately 60 percent of the procurement budget. The remainder of the procurement budget pays for less conspicuous items including the spare parts to operate existing equipment, less expensive systems like trucks and radios, and general and specialized support equipment. (These purchases might be considered "supporting" procurement in that they provide replenishment parts to existing stocks of weapons, buy complementary support equipment and otherwise purchase the hundreds of thousands of items not explicitly identified in the Selected Acquisition Report.)

DoD plans to increase substantially spending in these procurement categories during the next five years. Such increases come on top of substantial real increases since 1981. The Congress could choose to provide only half the real increases sought by DoD in 1985 in addition to inflation adjustments, and then continue the Administration's plans for 1986 from this somewhat lower base. This alternative would save an estimated $18.1 billion relative to Administration five-year plans.

Because these supporting procurement accounts pay for the more than three million spare parts and major equipment in DoD inventories, it is extremely difficult to estimate the impact of providing only half the real growth requested for one year. The cut could slow procurements. But the President's Private Sector Survey on Cost Control (PPSSCC) has identified numerous ways by which DoD might hold down costs in this area. Improved inventory controls, better procurement management, and expanded use of normal business procedures are potential methods they suggested to reduce DoD procurement costs. (CBO and GAO are currently evaluating the PPSSCC reports and will issue a report shortly.)

II-20. SLOW GROWTH IN OPERATION AND MAINTENANCE SPENDING

Savings from Admin. Request	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	2,500	2,800	3,200	3,400	3,800	15,700
Outlays	2,000	2,700	3,100	3,300	3,700	14,800

Approximately 15-20 percent of current DoD budget authority goes to support operation and maintenance (excluding civilian pay) of existing plant and equipment. This includes maintenance of existing equipment, training, purchasing fuel and spare parts, and funding base operations, as well as many other things. Together these activities are commonly referred to as "readiness" spending since they contribute directly to the day-to-day capabilities of the military forces. Since 1981, O&M spending has increased 10 percent in real terms. Administration plans call for funding for these items to increase over 60 percent during the next five years including anticipated inflation. (Not all details necessary to calculate real growth in the 1985-1989 O&M appropriation request were available at time of publication.) Presumably higher funding will place current forces at a higher state of combat readiness and effectiveness.

The planned additions to military forces during this period do not, however, seem to require these substantial increases in O&M. Based on force structure and modernization plans submitted with last year's budget (details of the 1985 plans were not available at time of publication), CBO projects that by 1989 tactical aircraft in the Air Force will increase 13 percent, while Navy tactical aircraft will grow by 7 percent; the number of ships will increase by 15 percent while the number of strategic aircraft will remain relatively constant. The number of active-duty personnel will increase by 6 percent. CBO estimates that the additional O&M spending required to support these new forces at today's spending rates would, by 1989, add only about 7 percent to real O&M spending over this period, much less than Administration increases. Beyond the 7 percent level, increases over the next five years would be spent for activities to improve current training or readiness.

The Congress could choose to limit the increases in the O&M accounts. A reduction of 3 percent in the O&M appropriation each year would produce substantial savings, $15.7 billion from 1985-1989, compared to Administration plans. During the past three years, the President and the Congress have reduced the O&M appropriations on the average by 3 percent a year.

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CHAPTER III. MEDICARE AND MEDICAID

Outlays for Medicare and Medicaid are projected to grow faster than the budget as a whole, primarily because costs throughout the medical care system are expected to rise rapidly. Moreover, without changes in policy, Medicare's Hospital Insurance trust fund is expected to be depleted in the early 1990s.

Medicare finances health services for 27 million persons aged 65 and over and nearly 3 million disabled persons. It consists of two programs--the Hospital Insurance (HI) program, which pays for inpatient hospital care, some stays in skilled nursing facilities, and limited home health services; and the voluntary Supplemental Medical Insurance (SMI) program, which primarily covers physician and hospital outpatient services. The HI program is financed by a portion of the Social Security payroll tax. Premiums paid by beneficiaries finance about one-quarter of the SMI program; the remaining three-quarters is funded by an appropriation from general revenues.

The Medicaid program provides matching funds to states to finance medical services for low-income persons who are in families with dependent children, or who are aged, blind, or disabled. 1/ Medicaid coverage varies by state, but always includes a broader array of services than Medicare. At present about 45 percent of Medicaid expenditures are for nursing home care and home health services.

BUDGET HISTORY AND PROJECTIONS

Spending for Medicare and Medicaid has increased markedly since the programs began in 1966--a trend projected to continue despite recent budget cuts. In 1965, spending on the predecessor program to Medicaid totaled $300 million, which was less than 0.1 percent of the gross national product. By 1983, the $76 billion spent on Medicare and Medicaid accounted for 2.3 percent of GNP. Projections show this proportion nearing 3 percent by 1990 (see Table III-1 and Figure III-1).

1. Federal matching rates are based on state per-capita income. In 1984 these rates will range from 50 to 78 percent. On average, the federal share of spending is 55 percent.

TABLE III-1. FEDERAL OUTLAYS FOR MEDICARE AND MEDICAID
(By fiscal year, in billions of dollars)

Major Program	Actual 1980	Actual 1983	Estimated 1984	Baseline Projection 1985	1986	1987	1988	1989
Medicare	35.0	56.8	65.6	75.2	84.0	94.9	107.5	121.1
Hospital Insurance	24.3	38.5	44.4	50.7	55.7	62.3	69.9	77.9
Supplementary Medical Insurance	10.7	18.3	21.2	24.5	28.3	32.6	37.6	43.2
Medicaid a/	14.0	19.0	20.7	23.4	25.1	27.3	29.8	32.5

a. Federal outlays only, which are about 55 percent of total program costs.

Start-up of the programs accounted for some of this growth in the early years, but increases in Medicare and Medicaid spending have mirrored the trend in overall health care expenditures. As Figure III-1 shows, national health spending as a share of GNP rose from 6 percent in 1965 to 10 percent in 1982, and is projected to near 12 percent by the end of the decade. 2/

This dramatic increase in the resources spent on health care reflects growth in both the prices of medical services and the volume of services delivered. Part of the volume increase represents improvements in the quality of care, resulting both from technological advances in the practice of medicine and from the greater access to care provided by wider availability of health insurance coverage--including private coverage as well as Medicare and Medicaid.

At the same time, however, widespread health insurance coverage may have encouraged medical care expenditures to rise faster than warranted by improvements in care. In this "third-party" system of payment, neither the provider nor the recipient of health care services has an incentive to control increases in the prices or the volume of services provided.

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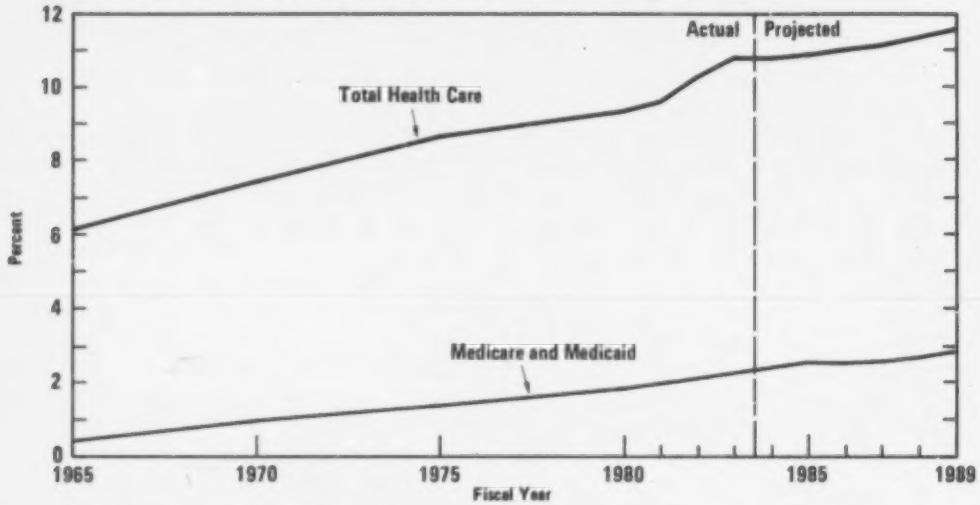
2. National health expenditures estimates from Mark S. Freeland and Carol E. Schendler, "National Health Spending in the 1980's: Integration of Practice Patterns with Management," Health Care Financing Review, forthcoming March 1984.

Figure III-1.

Health Care Spending as a Percent of GNP, 1965-1989



SOURCE: Congressional Budget Office.

NOTE: Data reflect five-year intervals 1965-1980 and annual intervals 1980-1989.

Medicare: Recent Spending Trends and Projections

Medicare outlays grew at an average annual rate of 18 percent between 1980 and 1983 compared with 11 percent for the budget overall. Although substantial spending reductions were enacted in the program during this period, their major effects will occur in 1984 and beyond. Despite these cuts, spending for Medicare is expected to reach $75 billion in 1985, when it will account for 8 percent of all federal spending.

The most significant budget cuts enacted in Medicare involve changes in the way hospitals are paid. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) instituted limits on relatively high-cost hospitals and on those with relatively high rates of increase in Medicare costs. At that time, these limits were projected to save nearly $7 billion over the 1983-1985 period. The Social Security Amendments of 1983 established a prospective payment system for hospitals that provides hospitals with a permanent system of strong incentives to reduce costs, but is not intended to achieve further savings until after 1985. Under the new system, prices will be set in

advance for each of 468 diagnostic categories, known as Diagnostic Related Groups (DRGs). 3/ Hospitals able to care for their Medicare patients at less cost than the payments they receive can keep the difference, while others must absorb the loss.

Other Medicare changes in recent years have increased payments by beneficiaries. SMI premiums, along with the deductible amounts in both HI and SMI, were increased. In addition, reimbursements to radiologists and pathologists were reduced from 100 percent of allowable costs to 80 percent, which is the standard for other physicians. Beneficiaries now pay the 20 percent differential. Further, federal employees began to pay the HI payroll tax in January 1983.

Despite these changes, Medicare outlays are projected to continue rapid growth between 1985 and 1989. Although lower than the projected annual increase in SMI of 15 percent, the expected yearly increase in HI of 11 percent has serious implications for the HI trust fund. The Congressional Budget Office projects that the HI trust fund is likely to be exhausted in the early 1990s because of the large discrepancy between growth in HI outlays and growth in payroll tax revenues. From then on, trust fund deficits are expected to grow quickly. Since the trust fund cannot run such deficits, very large reductions in spending, increases in taxes, or, most likely, a combination of both will be needed to ensure its continued solvency. 4/

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3. The program is designed to phase in over a three-year period, during which prices will be based in part on prospective hospital-specific rates, in part on 18 regional rates (separate urban and rural rates for each of the 9 Census divisions), and in part on a single national urban or national rural rate. The final system will have only national urban and rural rates. In all years, adjustments are made for local wage rates and medical education programs.

4. In fact, the policy options generally being discussed today would not likely be sufficient to maintain the trust fund's solvency. Even combinations of those discussed in this report are expected only to delay, not avoid, insolvency. For additional details on the HI financing problem, see Paul B. Ginsburg and Marilyn Moon, "An Introduction to the Medicare Financing Problem," in House Ways and Means Committee, Preliminary Papers for the Conference on the Future of Medicare, 98 Cong. 1 sess. (1983).

Medicaid: Recent Spending Trends and Budget Projections

Medicaid spending has grown more slowly than that of Medicare--11 percent a year between 1980 and 1983--primarily because of provisions in the Omnibus Budget Reconciliation Act of 1981 and changes made at the state level. The 1981 act lowered federal matching grants for 1982 through 1984, and granted states more flexibility in determining hospital reimbursement policies. In addition, the act restricted eligibility for the Aid to Families with Dependent Children (AFDC) program, which reduced the number of individuals automatically eligible for Medicaid.

Using their broad discretion to modify eligibility, benefits, and reimbursement, states have reduced Medicaid spending in response both to federal cutbacks and to recession-reduced state revenues. Two-thirds of the states have channeled some Medicaid recipients to lower-cost providers and have begun to substitute community-based care for more costly nursing home services. Among other reductions, states have imposed cost sharing, reduced the number of persons eligible for Medicaid, and lowered payments to hospitals.

Spending in the Medicaid program is projected to continue to grow more slowly than Medicare--even slower than the budget as a whole. Medicaid is projected to increase, on average, 9 percent a year between 1985 and 1989, compared to 10 percent for overall federal spending.

DEFICIT REDUCTION STRATEGIES

Two broad strategies are available for reducing spending in the Medicare and Medicaid programs. The first would lower spending directly by modifying the programs. The second would make changes aimed at the health system as a whole in order to reduce the rise in medical care costs, which is the underlying cause of rapid growth in these programs.

Many of the specific deficit-reduction options mentioned in this section are presented individually in greater detail at the end of the chapter. These individual items, which include estimates of their budget savings, are referenced when the option is mentioned.

Program Changes: Medicare

Three types of program changes are available to reduce Medicare spending. The first two would modify reimbursements to the providers of

health care services--physicians and hospitals. The third would require further cost sharing by Medicare beneficiaries. 5/

Limit Physician Reimbursement. Medicare bases its payment to a physician on "reasonable" charges, which may not exceed the lowest of three amounts: the physician's actual charge, his or her customary charge to Medicare for that service, or the applicable prevailing charge in the locality. Since 1976, annual increases in the prevailing charge have been limited by an economic index that reflects changes in physicians' office expenses and earnings levels of employees throughout the economy. Physicians who wish to charge their patients amounts in excess of reasonable charges may do so, however, by refusing to accept "assignment." 6/

Physician reimbursement could be limited in several different ways. For example, all physician fees could be frozen for one year or longer. Even a one-year freeze would generate savings in the future if subsequent increases did not allow a "catch-up" (Option III-1).

Other options would achieve savings while correcting what many consider to be flaws in the relative value of different types of physician services under the reasonable charge system. For example, a freeze only on surgical fees could reduce the current gap between payments for surgery and payments for other physician services. Another option would tie reimbursement for physician services performed in hospitals to the payments for similar services provided in physicians' offices, which are about 15 percent lower on average (Option III-2). A third option would change relative fees more directly by replacing the current system of reasonable charges with a fee schedule (Option III-3).

Physicians could avoid at least part of the lost income from any reimbursement reductions by increasing charges to Medicare beneficiaries and other patients. In addition, if physician payments were restricted for an extended period, the gap between ordinary charges and payments from

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5. For more discussion of cost sharing, see Congressional Budget Office, Changing the Structure of Medicare Benefits: Issues and Options, March 1983.

6. In Medicare, accepting assignment means billing the program for reasonable charges and collecting from the patient only the required deductibles and coinsurance. Physicians otherwise must bill the beneficiary, who in turn submits a claim to Medicare. Physicians must accept assignment, however, for the 14 percent of Medicare beneficiaries who are also Medicaid recipients.

Medicare would widen. Under these conditions, physicians might not be able to recoup enough of the differential by charging patients more, and might choose to limit their participation in Medicare. Competition for patients resulting from the growing numbers of physicians might prevent this from becoming a major problem, however.

Requiring physicians to accept assignment for all Medicare patients would prevent them from shifting costs to beneficiaries, but might also cause them to increase the volume of billed services--thereby lowering the savings achieved through reduced reimbursements. Greater volume might result either from changes in practice patterns (such as increases in patient visits) or from changes in billing practices (billing for extended office visits rather than short visits, for example). Establishing effective controls on such behavior would be difficult. Alternatives to mandating assignment--such as paying a higher proportion of reasonable charges to physicians who accept assignment for all of their Medicare patients--might not encourage such increases in volume, but would reduce savings.

Limit Hospital Reimbursement. Although hospital reimbursement has been the primary target for Medicare budget reductions in recent years, further savings could be achieved in three ways. First, tight limits on the increase in DRG payment rates over an extended period could achieve significant savings (Option III-4).

Second, hospital payments could be reduced by changing the treatment of costs that are currently excluded from the prospective payment rates. One example would be limiting payments for the direct costs of operating teaching programs for medical residents, which are now reimbursed on a cost basis (Option III-5). Similarly, reimbursements for hospital capital costs (depreciation, rent, and interest) could be limited. For example, revaluation of hospital assets acquired through purchase could be disallowed when calculating Medicare reimbursement (Option III-6). In addition, capital costs could be funded in the prospective rates in a way that would reduce total federal payments.

Third, incentives for higher hospital payments unintentionally created by the new prospective payment system could be removed. For example, because payments are on a per-case basis, hospitals have an incentive to raise their revenue by admitting Medicare patients more often. This incentive would be diminished if Medicare paid less for admissions above a target number (Option III-7). Another such option would be to include payments for home health and nursing home services in the hospital payment rates. Currently, hospitals have an incentive to discharge patients to these services as early as possible--particularly to hospital-owned services--in

order to generate revenues from Medicare over and above the DRG payments (Option III-8).

Expand Cost Sharing. Several approaches could be used to cut outlays by requiring Medicare beneficiaries to assume a greater share of their medical costs. 7/ The burden could be spread across most beneficiaries by raising SMI premiums (Option III-9). Alternatively, cost sharing could be tied to the amount of services used by increasing deductibles or by charging coinsurance or copayments (Options III-10 through III-13). 8/

In addition to the direct savings it would achieve, expanded cost sharing might discourage use of medical services and thus produce some indirect savings. For example, the incentive prospective payment gives hospitals to increase Medicare admissions might be moderated if beneficiaries were required to pay a deductible separately for each admission instead of once for each "spell of illness" (Option III-12). 9/ Because almost 80 percent of beneficiaries have supplemental insurance or Medicaid coverage that would insulate them from increased cost sharing, however, effects on use would probably be small.

If more cost sharing was required, steps could be taken to protect low-income beneficiaries and those with relatively high medical costs--for example, by placing a limit on total out-of-pocket payments. In addition, cost-sharing changes--including such a limit--could be designed to vary by income, as could any increases in the SMI premium. Some people, however,

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7. Except for payment of a deductible equal to the average cost of one day's hospitalization--$356 at present--Medicare covers in full the first 60 days of hospitalization for a spell of illness, which may involve more than one admission. Significant coinsurance is required for longer stays. After a $75 annual deductible, Medicare pays 80 percent of allowed charges for medical and health-related services and supplies, including payments to physicians and hospital outpatient facilities. Medicare does not cover some services, such as dental care and eyeglasses.

8. With coinsurance, the beneficiaries would pay a percentage of the charge; with copayments, they would pay a fixed dollar amount per service.

9. A spell of illness begins with an enrollee's first day of hospitalization and ends when the enrollee has not been an inpatient in a hospital or nursing home for at least 60 days.

oppose implementing means-testing provisions in Medicare on philosophical grounds. Also, with the exception of increasing SMI premiums, such provisions could be administratively complex.

Changing Medicare to a voucher system might be an alternative to major increases in cost sharing. Under such a system, beneficiaries would be entitled to a fixed voucher amount and then would be allowed to choose among a variety of benefit packages offered by private insurance companies, with different combinations of cost sharing and coverage. Federal liabilities would be limited to the fixed amount, which could be supplemented by the individual. To save federal revenues, vouchers--like cost sharing--would shift the burden onto beneficiaries, but they would also expand the range of choices available to beneficiaries. This approach would be a substantial change in Medicare's tradition, however, because coverage of a particular set of health care services would no longer be guaranteed. A major technical difficulty would be adverse selection--the tendency of particular plans to attract relatively healthy or relatively unhealthy beneficiaries. Under this process, plans with more extensive benefits could become very costly over time because they would primarily attract individuals expecting to need the most coverage, yet they would not benefit from subsidies generated by those who use few services. In addition, under a voucher system, Medicare would lose the negotiating advantage it currently enjoys as a major purchaser of health services.

Program Changes: Medicaid

Medicaid savings could be achieved through a number of program changes affecting reimbursement, benefits, and eligibility. These include mandating coinsurance for all Medicaid recipients (Option III-14) and restructuring benefits for the mentally retarded (Option III-15).

Extensive Medicaid program changes at the federal level would, however, remove the flexibility the 1981 reconciliation act granted to states--authority they have since used successfully in a variety of ways to reduce Medicaid spending. One option for budget savings in Medicaid that would maintain state flexibility is to transfer even more responsibility to the states by extending the reductions in federal matching grants enacted in 1981, which are due to expire in 1985 (Option III-16).

Health System Changes

A second broad approach to reducing federal spending for health care would make changes to slow growth in overall medical costs. Although

health system changes would not produce savings as immediately as program changes, in the long run they may be necessary to maintain the level of services provided by Medicare and Medicaid.

Mechanisms for Change. Three basic changes in the health system show promise for reducing the growth in medical care costs in the long run. One is the development of alternative delivery systems. Health Maintenance Organizations (HMOs) have been shown to provide care at lower cost than the traditional fee-for-service system, and other less comprehensive delivery arrangements might have similar effects. For example, some private insurance companies and large employers have established preferred-provider contracts under which relatively low-cost coverage is arranged with certain hospitals and groups of physicians.

A second change that could lower health care costs is increased cost sharing in traditional insurance. Studies have demonstrated that individuals facing higher deductibles and coinsurance use fewer health services.

Third, limits on payments to health service providers could slow growth in health care costs. In recent years, a number of states have developed systems of hospital cost containment involving all payers. These programs vary greatly; some are based on formula-determined increases, others on review of individual hospital budgets. Only one state (New Jersey) bases payment on DRGs. In the eight states in which all-payer prospective payment programs are mandatory, growth in hospital costs has been slowed substantially--to an average annual rate of 11 percent for per-capita inpatient hospital costs between 1976 and 1982, compared with 15 percent for other states.

Federal Options. The federal government clearly benefits from successful initiatives by state governments or the private sector to slow growth in health care costs. As growth in private-sector health spending slows, federal reimbursements for some forms of health care, such as physician services, automatically decline. Under prospective payment for hospitals, payment rates will not be lowered automatically, but if hospital costs grow more slowly the prospective rates could be set more stringently without encouraging differences in treatment between federal beneficiaries and others.

Two major options are available to the federal government to encourage further changes in the health care system that would slow the growth in spending. First, taxing employer-paid health insurance premiums could encourage both increased cost sharing and the development of alternative delivery systems (Option III-17). Currently, employees often prefer more expensive health benefits over pay raises in cash, because the former are

not taxed but the latter are. Making employer-paid health benefits above certain limits taxable would lead to more cost sharing and increased use of preferred-provider contracting. Cost-reducing effects are not likely to be felt quickly, however, so this approach could help to solve Medicare's financing problems only over the long run. In addition, requiring consumers to pay a greater share of the costs might limit access to care by lower-income individuals.

The second major federal option would require all payers to reimburse hospitals on a prospective basis, either through state programs or through a federally administered system (Option III-18). Physician fee schedules could also be developed for all payers. Although none of the existing state programs include physician reimbursement limits, such fee schedules are used in many other Western countries. One drawback to limiting either hospital or physician payments is the difficulty of doing so without causing increases in the volume of services or other undesired behavior.

Conclusion

Unless action is taken, spending for Medicare and Medicaid will continue to absorb a growing share of federal outlays. Achieving significant reductions through program changes alone might require that program goals be altered, while funding the current system would imply large increases in taxes. To avoid these outcomes, the fundamental problem of rapidly rising health care costs must be tackled directly. Slowing the growth in medical care costs would probably require actions to reduce growth both in prices per service and in the volume of services provided.

III-1. FREEZE PHYSICIANS' FEES PAID BY MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	830	950	1,100	1,250	1,400	5,530
Outlays	790	910	1,050	1,150	1,350	5,250

The level of reimbursement received by a physician under Medicare is based on the calculation of "reasonable" charges. This allowable charge may not exceed the lowest of the physician's actual charge, his or her customary charge for that service, or the applicable prevailing charge in the locality. Each year the prevailing charge is adjusted to account for inflation.

Rather than allowing charges to increase on July 1, 1984, customary and prevailing rates could be frozen at their June 30 level for one year. It would save about $5.3 billion over five years, $790 million of which would be saved in 1985. If restricted to hospital inpatient fees, the fiscal year 1985 savings would be $360 million.

Most of the recent cuts in Medicare reimbursement have focused on hospitals rather than physicians. In a time of fiscal stringency, it may be reasonable to ask all providers to share in cutbacks. Moreover, a fee freeze would not affect the current structure of physician reimbursement, and therefore would reduce outlays while allowing further study of more substantive structural changes.

A major concern with the freeze is its potential effect on beneficiaries. Beneficiaries would gain in two ways. All beneficiaries would face lower SMI premiums (increases in which are tied to the cost of SMI) and those whose physicians accept assignment would face lower cost sharing, because they would pay 20 percent of a lower amount. On the other hand, some beneficiaries could be worse off if, in response to the freeze, fewer physicians accepted assignment, and those who did not accept assignment offset the reduced reimbursements by extra charges to patients.

III-2. LIMIT MEDICARE'S REIMBURSEMENT TO PHYSICIANS FOR INPATIENT MEDICAL CARE

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	430	500	570	660	750	2,910
Outlays	410	470	540	630	720	2,770

Under Medicare's current system of reimbursement based on "reasonable" charges, differences in amounts paid to physicians for various services reflect historical patterns. For example, at least part of the higher allowed charges for inpatient as compared with office visits of comparable lengths reflects the fact that insurance coverage has been more widely available for services performed in the hospital.

Medicare could lower the prevailing and customary limits on reimbursements for inpatient visits to be comparable to similar office charges. This change in reimbursement could save $410 million in fiscal year 1985 and $2.8 billion over five years.

Such an adjustment would represent a first step toward tying physician reimbursements to the relative costs of providing different services, thereby redressing some of the current imbalances in charges.

Careful attention would be required, however, to determine when inpatient and office services were comparable. Moreover, little careful analysis is available on which to base guidelines for adjusting relative charge levels, so this option might simply trade one arbitrary set of physician charges for another.

III-3. ADOPT FEE SCHEDULES FOR PHYSICIANS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	1,400	1,500	1,700	1,900	2,150	8,650
Outlays	1,350	1,400	1,600	1,800	2,050	8,200

In place of the current system of reimbursement based on "reasonable" charges, Medicare could begin to move to a system of fee schedules--that is, a set amount of reimbursement for a particular service. Some variation in fees could be allowed, for example, by region or by the location where the service is performed (office, hospital, clinic). Fees could be based on studies of the time and skill needed to perform the service, and additional factors could be designed to encourage procedures and locations that are relatively cost-effective. Physicians would be offered a fee for a particular procedure--assuming no complications--that would be known in advance. If the schedules were set so that allowed charges were reduced by 5 percent overall, this would reduce federal outlays by $1.4 billion in 1985 and $8.2 billion over the next five years.

Fee schedules would allow Medicare more control over reimbursements. No longer would reimbursements necessarily be tied to relationships among types of services reflecting history rather than current relative difficulty. For example, fee schedules could more readily be adjusted to reflect changes in technology. They could also favor cost-effective procedures, such as those done on an outpatient basis. Finally, fee schedules could be used to address imbalances in the mix of medical specialties.

Many physicians might resist the adoption of fee schedules because it would mark a change from a passive stance on the part of Medicare to more active intervention in the physician services market. Some physicians might cease treating Medicare patients, particularly if steps were taken to prevent physicians from passing on additional costs to patients.

III-4. LIMIT INCREASES IN MEDICARE'S PROSPECTIVE PAYMENT RATES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-25	-100	-250	-330	-550	-1,255
Outlays	410	920	1,550	2,300	3,150	8,330

NOTE: Budget authority for the HI component of the Medicare program reflects all sources of income to the trust fund, including interest earned on reserves. Therefore, options that reduce outlays also allow reserves and interest to increase. This accounts for the different arithmetic sign of budget authority and outlays in some of the tables that follow.

Medicare's prospective payment rates to hospitals in 1985 will be set according to a statutory formula. But beginning in 1986 they will be adjusted annually at the discretion of the Secretary of Health and Human Services. The CBO baseline assumes the Secretary will allow annual increases equal to the growth rate in prices faced by hospitals (known as the hospital market basket) plus 1.0 percentage point.

If the Congress limited the 1985 and future-year Medicare payment rate increases to the changes in the hospital market basket--not allowing the extra 1.0 percentage point--the savings through 1989 would be $8.3 billion. Moreover, restricting the increase would give hospitals greater incentives to become more efficient and to avoid unnecessary procedures or those of limited value.

On the other hand, hospitals would also have incentives to make up for the reduced Medicare revenue by admitting more patients, raising outpatient fees, and charging more to non-Medicare patients. Hospitals with predominantly Medicare patient populations might be forced to cut back services or close. Finally, high-cost beneficial advances in medical treatment might not be available to Medicare patients.

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III-5. REDUCE MEDICARE'S PAYMENTS FOR DIRECT MEDICAL EDUCATION EXPENSES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	-5	-30	-65	-65	-100	-265
Outlays	240	260	290	320	360	1,470

NOTE: See note to table in Option III-4.

Medicare's prospective payment system currently excludes payments to hospitals for the direct costs of medical education (residents' and teachers' salaries and administrative costs). These costs are reimbursed in proportion to the share of the hospital's total costs generated by Medicare beneficiaries. If this passthrough were reduced by 25 percent beginning in fiscal year 1985, five-year savings would approach $1.5 billion.

The major argument for reducing direct medical education payments is that other federal programs that subsidize medical education have been cut back in recent years because of an expected surplus of physicians and budget stringency considerations. For example, new funding for Health Professions Student Loans was eliminated between 1981 and 1984. Continuing an unlimited passthrough of medical education costs under Medicare would be inconsistent with these cutbacks and with reductions in hospital payments made to address the financial problems of Medicare's Hospital Insurance (HI) trust fund. In addition, it is argued that the HI payroll tax is an inappropriate source for medical education subsidies, since those who benefit will generally earn incomes far higher than employees who pay the tax.

Because medical residents provide care to Medicare beneficiaries, however, setting a fair limit on the passthrough might be difficult. Few data are available to estimate how much of medical education costs cover patient care. If the share of the passthrough that was continued--75 percent in this estimate--were too low, other payers would be forced to subsidize care of Medicare patients.

Fewer physicians may be trained if hospitals responded to lower Medicare payments by cutting the size of their residency programs. While this might be desirable in those specialties experiencing the largest physician surplus, it could also restrict training of physicians in other areas such as primary care.

III-6. DISALLOW REVALUATION OF HOSPITAL ASSETS UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	*	*	-10	-10	-20	-40
Outlays	50	110	170	220	280	830

NOTE: See note to table in Option III-4.

Medicare pays all hospitals for its share of depreciation costs and pays investor-owned hospitals for its share of return on equity. These payments are often increased substantially when hospital assets are revalued at time of purchase, since revaluations frequently range between 50 and 100 percent. Disallowing revaluation for assets acquired in fiscal year 1985 and after would discourage transactions intended primarily for this purpose, and would achieve five-year savings of about $830 million, including $80 million in savings to Medicaid.

Proponents of eliminating revaluation argue that there is no justification for revaluing a facility simply because it was sold, and that the current system leads to different treatment of similar hospitals. Medicare bases depreciation payments on historical costs, and protects investors from inflation by reimbursing for incurred interest costs, and by tying return-on-equity payments to the rate of return earned by the Hospital Insurance trust fund--a policy consistent with that of most public utility regulators. If a hospital is sold and revaluation is made, the sellers receive a windfall from being compensated twice for inflation: once because of the policies just described, and once because the selling price will be higher since purchasers know they can revalue the assets. In particular, it is charged that some investor-owned hospital chains engage in buying and selling facilities solely to gain the additional reimbursement, and that prices are often bid up well above fair market value as a result.

On the other hand, disallowing revaluation would discourage acquisitions that might benefit some communities. In many cases, proprietary hospitals purchase older, public facilities in rural areas, modernize them, and guarantee provision of care to indigents. Without revaluation, such purchases would be less likely.

III-7. LIMIT MEDICARE'S PAYMENTS FOR EXCESS HOSPITAL ADMISSIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-15	-60	-140	-180	-300	-695
Outlays	250	510	820	1,250	1,700	4,530

NOTE: See note to table in Option III-4.

Under the new prospective payment system, hospitals have an incentive to increase admissions of Medicare patients because payment is made on a per-case basis. This can be done by shifting some treatments from an outpatient to an inpatient basis, or by encouraging physicians to admit patients twice--once for diagnosis and later for surgery.

One way to weaken this incentive and thereby reduce growth in Medicare costs would be to set areawide admission targets equal to the growth in the size of the beneficiary population. Only if the hospitals in the area exceeded the target as a group would penalties--for example, reimbursement at 60 percent of the normal rate--be imposed on individual hospitals experiencing excess admissions. This approach could save $4.5 billion over the 1985-1989 period, assuming that the penalty would reduce the number of excess admissions by one half.

Devising a system that would be fair to all hospitals might be difficult, however. Factors that might legitimately raise admissions rates above the target--such as an increase in the very old population, or an influenza epidemic--would have to be considered, perhaps on an appeals basis. Moreover, to the extent that increasing admissions rates reflect improvements in quality--such as hospitalization for conditions previously not treated--Medicare beneficiaries might be adversely affected by such controls. Already, under the prospective payment system, increases in the payment rates to allow for technological improvements will probably be limited by the financial difficulties of the Hospital Insurance trust fund.

III-8. INCLUDE NURSING HOME AND HOME HEALTH PAYMENTS IN MEDICARE'S HOSPITAL PAYMENT RATES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	-5	-30	-80	-110	-190	-415
Outlays	130	300	530	820	1,110	2,880

NOTE: See note to table in Option III-4.

Increased payments for home health and nursing home services may become an unintended outcome of Medicare's new prospective payment system for hospitals. Because hospitals receive the same payment regardless of how long a Medicare patient stays, they have an incentive to discharge patients as early as possible. In particular, hospitals that provide nursing home and home health services can increase their revenue by shortening inpatient stays and increasing use of these services for which Medicare pays separately. Although home health services are generally less expensive than inpatient hospital care, Medicare costs could rise.

If the hospital payment rates included payments for nursing home and home health services following an inpatient stay, this incentive would be eliminated. Five-year savings of $2.9 billion would result, partly from ending the incentive and partly from limiting the expected growth rates in home health services (outlays for home health care are projected to increase 20 percent annually, compared to 12 percent for hospital payments).

Eliminating the separate reimbursement for home health care might reduce provision of services, however. Most of the increase in outlays for home health services has been due not to higher prices but to greater use of these services, which are often prescribed to avoid institutionalization or to decrease dependency on family members. Hospitals might encourage physicians to restrict prescription of home health services to only the most needy cases.

In addition, including nursing home and home health services in hospital payment rates might pose technical problems. If prescription of these services is not evenly distributed across hospitals, hospitals that currently discharge very few patients to them would receive a windfall, while for others the adjustment might not cover actual costs. Moreover, data limitations might make it difficult to determine the appropriate adjustment factor for each diagnostic group.

III-9. INCREASE THE SMI PREMIUM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	890	1,700	2,400	3,250	4,250	12,490
Outlays	890	1,700	2,400	3,250	4,250	12,490

Medicare's Supplementary Medical Insurance program is partially funded by monthly premiums--currently $14.60--paid by beneficiaries. Between 1972 and 1982, premium receipts covered a declining share of SMI costs--from 50 percent to 25 percent--because the formula for calculating premium increases was limited to the rate of growth in Social Security benefits, which is tied to the Consumer Price Index rather than to the faster-rising per capita cost of SMI. In 1982, a change was enacted to set premiums through 1985 to cover 25 percent of the costs incurred by an aged enrollee. After that date, the premium calculation will again be limited to the rate of growth of Social Security benefits. If the premium were set so that participants would pay 30 percent of costs beginning January 1, 1985, savings would total $890 million in fiscal year 1985 and $12.5 billion over the five-year period. Premium costs would rise to an estimated average of $19.90 per month on January 1, 1985, instead of the scheduled $16.60.

This option would spread the increased payments across all enrollees, rather than target only those who use medical services. Moreover, it would not affect the poorest of the elderly and disabled since they are likely to be eligible for Medicaid, which usually pays the SMI premium on their behalf. On the other hand, some elderly and disabled persons would find the increased premiums burdensome. Some might drop SMI coverage and either do without physicians' care or turn to sources of free or reduced-cost care, increasing demands on local governments.

This option could be limited to single persons with incomes above $25,000 and to couples with incomes over $32,000--the thresholds used for taxation of Social Security benefits. Total savings would fall to $1.7 billion but could be increased to $2.7 billion if the participant's share was increased to 35 percent of costs. While the increased premiums would affect only higher-income elderly and disabled persons, there would be some technical difficulties--for example, those with incomes just above the income cutoff would be treated much more severely than those just below the cutoff, unless adjustments were made.

III-10. INCREASE THE SMI DEDUCTIBLE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	240	400	600	800	950	2,990
Outlays	200	350	550	750	900	2,750

The deductible amount that beneficiaries must pay before Medicare covers Supplementary Medical Insurance benefits is now $75 per year. This deductible has been increased only twice since Medicare began serving beneficiaries in 1966, when it was initially set at $50. Average per capita benefits have increased much more rapidly over that period.

The SMI deductible could be increased to $100 on January 1, 1985, and indexed thereafter to the rate of growth of per capita SMI reimbursements. This option would save $200 million in fiscal year 1985 and $2.8 billion over the five-year period.

Such an increase would bring the SMI deductible more closely into line with deductibles commonly charged under private insurance plans. It would also spread the burden of reduced federal outlays across most beneficiaries, raising their out-of-pocket costs by no more than $25 each in 1985.

Even relatively small increases in out-of-pocket costs could prove burdensome to low-income beneficiaries who do not qualify for Medicaid, however. Moreover, since most beneficiaries will exceed the deductible in any year, deductible amounts in this range do little to increase incentives for more prudent consumption of medical care.

III-11. EXPAND COINSURANCE FOR HOSPITAL CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-100	-320	-600	-610	-860	-2,490
Outlays	1,600	1,800	2,100	2,350	2,600	10,450

NOTE: See note to table in Option III-4.

Under current provisions, Medicare hospital patients pay a deductible amount equal to the average cost of one day's hospitalization--$356 in 1984. They pay coinsurance charges (generally 25 percent of the deductible amount) only after 60 days of hospitalization for a particular spell of illness. Consequently, only about 0.6 percent of enrollees pay hospital coinsurance in any year.

In addition to the first-day deductible, beneficiaries could be required to pay 10 percent of the cost of an average day's hospitalization for each of the next 29 days of a hospital stay in each calendar year--about $40 per day in 1985. For stays of 61 or more days, Medicare would cover all charges, thus improving coverage for participants with extended hospital stays. This option implicitly sets a maximum yearly out-of-pocket individual liability for hospital coinsurance of $1,170 in 1985. If the Medicaid program continued to pay the coinsurance costs for elderly and disabled persons enrolled in both programs, this proposal would save $10.5 billion over the next five years, but would increase state Medicaid outlays by $850 million.

Under this proposal, all Medicare beneficiaries would be protected from paying some costs associated with a very long hospital stay. In addition, expanded coinsurance should lead to a small reduction in use of services.

Out-of-pocket costs would rise substantially, however, for most of the elderly and disabled who were hospitalized. Costs would rise directly for those without supplemental coverage, and the cost of insurance would rise for those who purchased such policies. In any one year, only a small number of Medicare participants would have lower out-of-pocket costs as a result of the improved catastrophic coverage, whereas the potential $1,170 in additional cost sharing represents about 11 percent of average per capita

income for the elderly. In addition, since physicians' fees are currently subject to coinsurance under Part B of Medicare, the burden of an illness requiring hospitalization could rise well over $2,000. Moreover, persons ineligible for Medicaid who could not afford the cost sharing might forgo some needed medical care.

A modification of this hospital coinsurance option would be to set the coinsurance rate at 5 percent of the hospital deductible for days 2 through 30, resulting in savings of $1.2 billion over five years if the coinsurance on later days were also eliminated. Savings would increase to $5.1 billion over five years if the 5 percent coinsurance were expanded to days 2 through 60 in any year. Although few persons have stays in excess of 30 days in any year, out-of-pocket costs for these individuals would be relatively high, particularly since in addition to hospital coinsurance as high as $1,190 in 1985, patients would likely have large amounts of other expenses such as for drugs or physician coinsurance.

III-12. INCREASE COST SHARING THROUGH THE HOSPITAL DEDUCTIBLE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-270	-560	-930	-980	-1,350	-4,090
Outlays	1,900	2,200	2,550	2,900	3,350	12,900

NOTE: See note to table in Option III-4.

Medicare beneficiaries must now pay a deductible of $356--the amount equal to the average cost of one day's hospital stay--on the first day of hospitalization during each spell of illness. No deductible is charged for additional hospital stays if they occur within the same spell of illness--that is, if the patient returns to the hospital in less than 60 days after the last discharge date.

The number and frequency of deductible charges could be increased, for example, by charging a deductible amount for each admission during the year and, for the first admission in a year, charging the deductible for the second day of the stay as well. This specific use of increased cost sharing might discourage some unnecessary admissions. In fiscal year 1985, this option would generate almost $2 billion in savings. Savings for five years would near $13 billion.

The new prospective payment system for hospital reimbursement should help to limit extended hospital stays once patients are well enough to be released, but may actually encourage admissions for procedures or tests that could be done on an outpatient basis. This option would reduce that problem by requiring patients to share the burden of costs for each hospital stay.

On the other hand, for the few beneficiaries with unavoidable multiple stays, out-of-pocket costs could be high. For example, about 2.5 percent of beneficiaries have three or more hospital stays in a year.

III-13. TAX PREMIUMS FOR "MEDIGAP" POLICIES

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	2,800	4,100	4,600	5,300	6,000	22,800

To reduce their out-of-pocket payments for deductible amounts and coinsurance, over 60 percent of all Medicare participants purchase (or receive from employers) private coverage to supplement Medicare--known as "Medigap" policies. The plans vary widely, but often pay all the cost-sharing portions of Medicare. Persons with Medigap coverage use services at a higher rate than those with only Medicare, yet Medicare pays most of the costs of these additional services (for example, 80 percent of physicians' reasonable charges).

To recoup the extra federal outlays arising from supplemental coverage, a tax of 30 percent could be imposed on premiums for Medigap policies that pay any part of the first $1,000 of Medicare cost sharing. This proposal would not affect insurance protection for unusually large health costs. Federal savings would stem both from the premium tax receipts and from a reduction in health care use by those who would drop Medigap coverage because of the increase in its cost. The additional revenues, which could be dedicated to the two Medicare trust funds, plus the outlay reductions would total $2.8 billion in 1985 and $22.8 billion over the 1985-1989 period.

This option would lead to more equal government aid among all participants by requiring those with Medigap coverage to bear the additional costs they impose on Medicare. Moreover, the rise in use of services would probably decline slightly, thereby helping to slow the growth in health care costs. Finally, very low-income elderly and disabled persons would not be affected, since Medicaid pays their deductible amounts and coinsurance.

The premium tax would, however, increase the cost of Medigap policies and therefore discourage their purchase. Some who would otherwise have purchased supplemental coverage would have trouble meeting out-of-pocket costs during a year of unusually high medical expenditures.

III-14. REQUIRE COINSURANCE FOR ALL MEDICAID RECIPIENTS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	90	100	100	100	110	500
Outlays	90	100	100	100	110	500

Under Medicaid, the federal and state governments share the costs of providing medical care to certain low-income persons. In 1982, the Tax Equity and Fiscal Responsibility Act expanded states' options to impose cost sharing on recipients of Medicaid services. Today states can apply coinsurance to all recipients except children, pregnant women, and recipients who must spend most of their income for medical expenses. Few states have chosen to impose coinsurance to the extent permitted by law. Requiring them to impose nominal cost sharing for inpatient and outpatient services, as proposed by the Administration's 1984 budget, would save $500 million over the next five years. For most recipients, cost sharing would be $1 per physician visit and $1 per day of hospital care.

Proponents of this measure argue that imposition of cost sharing would lower expenditures by reducing unnecessary use of services by recipients. Evidence indicates that low-income persons, like those with higher income, reduce their use of medical care in response to cost sharing.

On the other hand, critics argue that cost sharing for Medicaid recipients would deter use of needed medical care. Recent evidence from the Rand Health Insurance Experiment indicates that low-income persons with health problems benefit from the extra services they use when no cost sharing is present.

III-15. PROVIDE INCENTIVES FOR COMMUNITY-BASED CARE OF THE MENTALLY RETARDED UNDER MEDICAID

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	250	570	960	1,450	2,050	5,280
Outlays	250	570	960	1,450	2,050	5,280

Under Medicaid, the federal government shares state costs of providing medical care to certain low-income persons according to a matching rate formula. Since 1972, the federal government has reimbursed states under Medicaid for intermediate-care facility services provided to the mentally retarded in state-run facilities. Outlays for this service have risen more rapidly than for any other service, increasing at an average annual rate of 33 percent between 1977 and 1982. Many of the mentally retarded now in large institutions could be cared for in less expensive community-based settings.

Providing Medicaid matching funds for community-based care could encourage states to deinstitutionalize many of the mentally retarded. The matching rate could be the same as for other services or, to encourage states to adopt community-based care for the mentally retarded more rapidly, it could be set 5 percentage points higher. Taken alone, this change would probably increase federal spending since the eligible population would include some of those receiving community-based care now, as well as those who were deinstitutionalized in the future. Consequently, to achieve federal savings, the annual increase in matching payments to states for services provided to the mentally retarded could be limited to 10 percent, about the overall rate of growth in the Medicaid program. Limiting growth in this benefit could save $5.3 billion over the next five years.

This change in funding of services for the mentally retarded would increase the incentives for states to develop less costly alternatives to institutional care and to operate their facilities for the mentally retarded more efficiently. On the other hand, reduced funding could decrease the quality of care received by the mentally retarded in some states. Savings from increased use of community-based care might not be sufficient to offset all of the loss in federal funding, and states might not make up the difference. Also, basing the maximum matching grant on current spending for institutional care would not necessarily target funds to states where the need is greatest.

III-16. CONTINUE PENALTIES FOR LARGE INCREASES IN STATE MEDICAID SPENDING

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	520	320	420	510	620	2,390
Outlays	520	320	420	510	620	2,390

The federal government shares with the states the cost of providing medical care to certain low-income families through the Medicaid program. In recent years, growth in federal outlays for this program has slowed, in part because of penalties on those states that exceed targets for Medicaid spending set in the Omnibus Budget Reconciliation Act of 1981. Under provisions of this act, the government deducts a penalty from each state's matching grant for Medicaid. States may receive a refund of the penalty, if their Medicaid expenditures are less than the target, but few states are expected to qualify for refunds in 1984. Once a state exceeds its target, it is unlikely to reduce expenditures below the target level in following years. These penalties expire at the end of 1984; extending a 3 percent penalty to 1989 could save $2.4 billion over the next five years.

Reducing Medicaid expenditures in this way would maximize state discretion. States could decide whether to replace the lost federal funds with their own funds or, if program cuts were to be made instead, they would control the necessary program changes. In contrast, achieving the same level of savings through federal changes in eligibility, benefits, or reimbursement could disrupt measures states have already taken to limit Medicaid costs.

A problem with these penalties is that state targets do not reflect factors, other than inflation and high unemployment, that raise Medicaid costs. For example, the targets do not allow for the increasing size of the elderly population, nor do they allow for changes in technology or in medical practice that affect the use of health services.

If this system of targets and penalties were extended, eventually all states would exceed their target and, thus, not qualify for a refund of the penalty. A reduction of 1.0 percentage point in each state's matching rate would be easier to administer and would save about the same amount.

III-17. TAX SOME EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Income Tax	1,300	2,600	3,400	4,500	5,700	17,500
Payroll Tax	500	900	1,300	1,600	2,100	6,400

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce 1985 income tax revenues by about $23.5 billion--an amount comparable to total federal spending for Medicaid, the major program financing health care services for the poor. This form of income also escapes payroll taxation, costing the Social Security trust fund an additional $8.2 billion in lost 1985 revenues.

One proposal for limiting the present exclusion would be to treat as taxable income in 1985 any portion of employer contributions exceeding $200 a month for family coverage and $80 per month for individual coverage, with the amount indexed to medical care prices in future years. In 1985, such a limitation would affect about 20 percent of those who participate in employer-sponsored health insurance plans. This is similar to the approach already adopted by the Congress in connection with employer-paid group life insurance. The proposal would raise income tax revenues by $1.3 billion and payroll tax revenues by $0.5 billion in 1985. Over the 1985-1989 period, the revenue increases would amount to $17.5 billion and $6.4 billion, respectively. Any "grandfathering" of current high-cost health insurance plans would reduce these amounts. A similar proposal contained in the Administration's 1984 budget was not acted on by the Congress.

Both health-policy and tax-policy arguments have been made for limiting this exclusion. The exclusion leads to what many consider to be overly extensive health insurance coverage, which has expanded use of health care services unnecessarily and, consequently, driven up their prices. Moreover, the provision disproportionately benefits persons with higher incomes, both because they tend to have somewhat larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets. The average annual tax benefit from excluding employer-paid health insurance premiums in 1983 for all households with incomes between $10,000 and $15,000 is estimated at $83; for all households with incomes between $50,000 and $100,000, it is $622.

Opponents of taxing any portion of employer-paid health insurance argue that even those with the most extensive health insurance coverage are not covered excessively and that changing the current policy would lower their insurance coverage; this might, in turn, cause some of them to forgo some forms of medical care. Also, they argue that a uniform ceiling would have uneven effects, since a given employer contribution purchases different levels of coverage depending on several factors such as geographic location and the demographic characteristics of the firm's work force.

III-18. REQUIRE ALL PAYERS TO LIMIT HOSPITAL PAYMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-20	-90	-220	-290	-480	-1,100
Outlays	370	780	1,350	2,000	2,700	7,200

NOTE: See note to table in Option III-4.

Beginning in 1986, the Secretary of Health and Human Services will determine the maximum annual permissible increase in Medicare's prospective payment rates to hospitals. That increase will probably be based on the projected rise in prices faced by hospitals (known as the hospital market basket). Hospitals would have greater incentives to resist upward pressure on the price of the hospital market basket if their payments for all patients, not just Medicare patients, were subject to controls.

If an all-payer hospital cost control system began in 1985, five-year savings to Medicare could total $7.2 billion. This estimate assumes the cost of the hospital market basket would increase by 0.5 percentage points less each year than under the CBO baseline.

Eight states now have mandatory state-run all-payer hospital cost containment systems, which vary greatly in detail. Those states averaged an 11 percent annual increase in per capita inpatient hospital expenses between 1976 and 1982, compared to 15 percent in states without such systems. Under the option described here, all states would be required to establish an all-payer hospital cost control program, with the details left to each state so long as it met federal performance standards.

While this option would hold hospital costs down, it also involves implementing regulatory systems that may prove cumbersome and that may discourage alternative cost containment strategies. For example, schemes designed to encourage hospitals to lower costs through competition--such as preferred-provider contracts or Health Maintenance Organizations--might be less likely in a regulated environment.

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III-19. INCREASE THE HOSPITAL INSURANCE PAYROLL TAX

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	16,900	18,400	19,200	20,450	21,800	96,750

The Hospital Insurance (HI) program, which accounts for almost 70 percent of Medicare outlays, is financed by a portion of the Social Security payroll tax. Employers and employees covered by the HI program each contribute 1.3 percent of earnings (currently up to a maximum tax of $491 on earnings of $37,800). The rate is scheduled to increase to 1.35 percent in 1985 and 1.45 percent in 1986, and the taxable earnings ceiling rises along with average wages.

Increasing the HI payroll tax would reduce the budget deficit and help maintain the solvency of the HI trust fund--which is projected to be depleted in the early 1990s--without affecting benefit levels. A 0.5 percentage-point increase in the tax rate (for both employers and employees) beginning in 1985 would generate $97 billion in revenues over the 1985-1989 period, and would delay depletion of the trust fund.

On the other hand, some argue that payroll taxes are already too high. Currently scheduled increases mean that the combined Social Security tax rate will have increased by 3.6 percentage points between 1975 and 1990. Moreover, Social Security payroll taxes already account for an increasing share of total federal revenues--rising from 26 percent in 1980 to about 34 percent in 1989. Further increases in the payroll tax could have adverse effects on employment, because the cost of hiring workers would rise. In addition, this option would increase the relative, as well as the absolute, tax burden of those with lower earnings, because the tax applies only to earnings below a limit.

CHAPTER IV. SOCIAL SECURITY AND OTHER ENTITLEMENTS

Outlays for Social Security and other nonhealth entitlement programs are projected to grow from an estimated $315 billion in 1984 to $418 billion in 1989. Because other components of federal spending are expanding more rapidly, however, these outlays will decline as a portion of the budget--from 37 percent in 1984 to 31 percent in 1989. In general, these entitlement programs pay benefits to all individuals, families, businesses, or governments that apply and meet the eligibility requirements. Thus, the level of outlays in entitlement programs is typically determined by program rules that establish eligibility standards and set benefit formulas, and by the actions of those who are potentially eligible, rather than by annual appropriations.

The entitlement programs discussed in this chapter may be broadly classified either as benefit payments to individuals or as payments to producers or jurisdictions (for more detail, see text box on following page). 1/ Benefit payments for individuals may be further divided into Social Security and other non-means-tested programs, means-tested programs such as Supplemental Security Income (SSI), and partially means-tested programs such as the National School Lunch Program. The remaining entitlements can be subdivided into those that provide support to producers, such as agricultural price supports, and those that provide funds for governments, such as General Revenue Sharing.

BUDGET HISTORY AND PROJECTIONS, 1965-1989

The share of national resources devoted to nonhealth entitlement programs rose from 5.4 percent of the gross national product in 1965 to 10.1 percent in 1983, but is projected to decrease somewhat over the rest of the decade (see Figure IV-1). The increase in the proportion of GNP spent on these entitlements was particularly dramatic during the 1970-1975 period--

1. For the purposes of this chapter, the term "entitlement programs" refers to nonhealth entitlement programs and other mandatory spending. Although outlays for military retirement benefits are included in the totals for entitlement spending, options concerning changes in military retirement are discussed in Chapter II. The health entitlements, Medicare and Medicaid, are discussed in Chapter III.

TYPES OF ENTITLEMENT PROGRAMS

Non-Means-Tested Programs. These programs pay cash benefits to individuals and families on the basis of factors such as age, disability, unemployment, and previous earnings, regardless of the beneficiary's income. This category includes, among others, Social Security, Railroad Retirement, Veterans' Compensation, Unemployment Insurance, and Civil Service Retirement.

Means-Tested Programs. These programs limit beneficiaries to those meeting certain criteria relating to income and other general characteristics as well, such as assets, age, disability, and presence of dependent children. The major programs in this category are Aid to Families with Dependent Children, Food Stamps, Supplemental Security Income, and Veterans' Pensions.

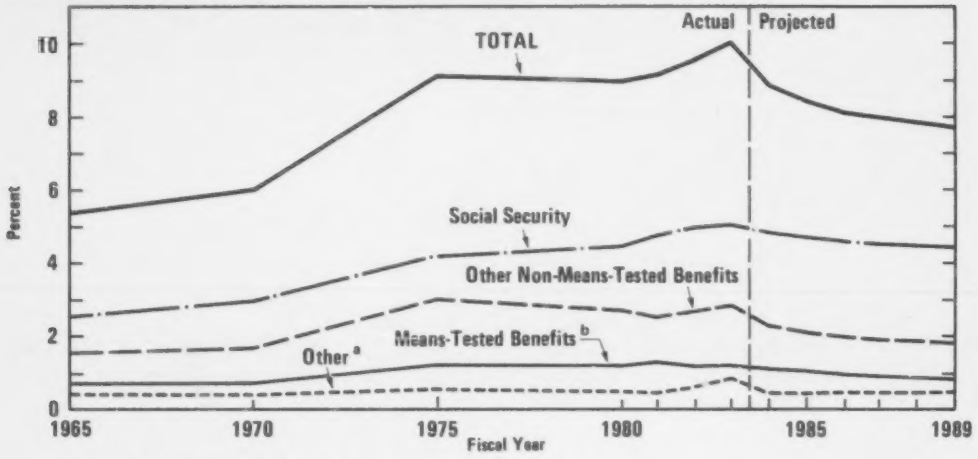
Partially Means-Tested Programs. These entitlements are programs that, while directing benefits more toward lower-income participants, have much less stringent eligibility requirements concerning income than do the means-tested programs. For example, all children participating in the National School Lunch Program received a minimum subsidy of 12 cents per meal, but those with incomes below 130 percent of the poverty line receive $1.20 per meal. This category also includes the other child nutrition programs and the Guaranteed Student Loan program.

Agricultural Support Programs. These programs support farm incomes either directly or through the maintenance of crop prices above market levels.

Payments to Jurisdictions. These programs supply funds to state and local governments to assist them in providing local services or to lessen tax burdens. The major programs are General Revenue Sharing and the Social Services Block Grant under Title XX of the Social Security Act.

rising from 6 percent to 9.1 percent. In many programs, eligibility was expanded and benefit levels were increased. In addition, automatic cost-of-living adjustments (COLAs) were instituted for a number of the major cash benefit programs during this period, although the major growth in spending associated with COLAs came after 1975.

Figure IV-1.
Social Security and Other Entitlements Spending as a Percent of GNP, 1965-1989



SOURCE: Congressional Budget Office.

NOTES: Excludes health care entitlements, which are treated in Chapter III. Data reflect five-year intervals 1965-1980 and annual intervals 1980-1989.

[a] "Other" includes agricultural price supports and governmental support programs.

[b] Means-Tested Benefits includes the Guaranteed Student Loan program and the child nutrition programs.

Outlays in all areas of entitlements except agricultural price supports and governmental support programs have risen substantially relative to GNP since 1965. Social Security, by far the largest of the entitlement programs, accounts for 55 percent of nonhealth entitlement spending, and in 1984 equals 4.9 percent of GNP, almost double its share in 1965. Other non-means-tested benefits to individuals have grown at roughly the same rate, but these programs make up only one-quarter of overall entitlement spending and about 2.4 percent of GNP. The means-tested benefit programs, along with the partially means-tested programs, now represent about 13 percent of entitlement spending, or about 1.1 percent of GNP, about 50 percent more than the proportion in 1965 but down somewhat from their peak in 1981. The remaining component of entitlement spending--agricultural price supports and payments to jurisdictions--now accounts for about 5 percent of total entitlement outlays, and is roughly the same percentage of GNP as it was in 1965.

Under current policies, spending for entitlements other than health is projected to rise by about 6 percent annually between 1984 and 1989, with Social Security and other non-means-tested benefits growing most rapidly (see Table IV-1). Growth in these programs is expected to be much slower than during the 1980-1983 period, however, because of recent legislative action and also because the projections assume sustained economic growth and relatively low rates of inflation. Federal outlays for means-tested benefit programs are expected to rise even more slowly.

Growth in entitlement spending--both past and future--results largely from two causes:

- Demographic and economic factors that cause beneficiary populations and benefit levels to grow under existing program rules; and
- Legislative actions that introduce new programs or modify program rules, thus expanding or restricting eligibility and changing benefits.

The 1965-1980 Period

The Social Security program offers a good example of how the foregoing factors affect outlays. Because the aged population was growing, the number of persons eligible for Social Security old-age benefits would have increased by about 65 percent over the 1965-1980 period without any program changes. In addition, increases in nominal wage levels would have raised the benefits of new retirees, even if automatic indexing had not been introduced.

In fact, Social Security outlays increased about 680 percent, with the difference caused by frequent legislative activity. There were four ad hoc benefit increases between 1965 and 1971; eligibility was expanded to cover postsecondary students and divorced spouses in 1965 and disabled widows and widowers in 1967. But the single piece of legislation most responsible for the growth in spending was the 1972 Amendments to the Social Security Act, which raised benefit levels by 20 percent and instituted automatic price indexing of the benefit formula for both current and future recipients. In this case, the interaction of legislation and economic factors resulted in a rapid growth in spending, partly because the particular indexing method used caused benefits for future retirees to be extremely sensitive to the rate of inflation, which in turn was much higher than projected. Although this indexing method was amended in 1977 for future beneficiaries, individuals who became eligible for benefits between 1974 and 1978 still receive benefits based on the previous, more generous formula. These legislative

TABLE IV-1. FEDERAL OUTLAYS FOR SOCIAL SECURITY AND OTHER ENTITLEMENTS
(In billions of dollars)

Major Program	Actual 1980	Actual 1983	Estimated 1984	Baseline Projection 1985	1986	1987	1988	1989
Benefit Payments for Individuals								
Non-Means-Tested Programs								
Social Security	116.1	164.9	173.4	184.3	196.5	210.7	226.8	242.7
Railroad Retirement	4.7	5.7	5.7	5.9	6.1	6.4	6.6	6.8
Military Retirement	10.1	15.9	16.7	17.6	18.9	20.1	21.3	22.6
Civil Service Retirement	14.7	20.6	21.9	23.4	25.2	27.1	29.0	31.0
Veterans' Benefits	11.0	12.8	12.9	12.9	13.0	13.4	13.8	13.9
Unemployment Insurance	15.7	31.5	21.5	19.7	17.7	17.8	18.1	18.5
Other a/	11.7	6.5	6.2	6.2	6.9	6.8	7.4	7.2
Means-Tested Programs								
Aid to Families with Dependent Children	7.3	7.9	8.0	8.0	8.2	8.5	8.8	9.2
Supplemental Security Income	6.4	8.7	8.3	9.3	9.7	10.2	11.6	13.3
Veterans' Pensions	3.6	3.9	4.0	4.0	4.1	4.2	4.3	4.4
Food Stamps	9.1	11.8	11.3	11.0	11.8	12.2	12.8	13.5
Other b/	1.4	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Partially Means-Tested Programs								
Guaranteed Student Loans	1.4	2.6	2.9	3.1	3.1	3.1	3.1	3.0
Child Nutrition Programs	3.4	3.3	3.4	3.6	3.8	4.0	4.2	4.4
Payments to Producers and Jurisdictions								
Agricultural Price Supports	2.7	18.8	7.3	9.0	11.9	13.1	14.7	17.8
Other c/	10.0	7.9	8.7	8.7	8.8	9.0	9.4	9.7
Total	221.1	325.3	314.6	327.9	348.1	369.0	394.1	418.3

SOURCE: Congressional Budget Office.

a. Other includes programs such as Black Lung, railroad unemployment insurance, and other mandatory spending.
b. Other includes outlays for the earned income tax credit and programs such as child support enforcement, and nutrition assistance to Puerto Rico.
c. Other includes General Revenue Sharing and the Social Services Block Grant.

changes achieved one major goal, however: the poverty rate for the elderly (based on cash incomes only) dropped from 28.5 percent in 1966 to 15.7 percent in 1980, largely because of higher Social Security benefits.

Similarly, in other non-means-tested programs, the number of eligible individuals and average benefit levels grew over this period for demographic, economic, and legislative reasons. In Civil Service Retirement, spending grew because of an increase in the number of federal workers reaching eligibility age but more importantly because of the automatic price indexing of benefits. 2/ Unemployment Insurance (UI) outlays grew both because of higher unemployment rates and growth in nominal wages, and because of legislated expansions of the covered work force and the provision of extended benefits during periods of high unemployment. Some spending increases resulted primarily from new legislation, such as the Black Lung program, which was created in 1969 and began paying benefits in 1970.

Spending for means-tested programs expanded in the 1965-1980 period because of growth in the eligible population, the extension of existing programs, and the creation of new programs. Spending for the Aid to Families with Dependent Children (AFDC) program, for example, increased dramatically, primarily because of the 91 percent increase in the number of female-headed families with children under 18 that occurred between 1970 and 1980. The Food Stamp program also grew during this period, from demonstration projects in a relatively small number of counties into a national program that replaced the food distribution program previously in place. And in 1972, the Congress passed legislation consolidating assistance programs for the aged, blind, and disabled into the SSI program, which established a national minimum benefit level that in some states was higher than in the predecessor programs.

Growth in the remaining components of entitlement spending has resulted primarily from the creation of new programs, including the School Breakfast Program and General Revenue Sharing. One major exception is agricultural price supports, where legislation over this period substantially limited federal assistance.

The 1980-1983 Period

During the 1980-1983 period, growth in these programs was slowed, and in some cases reversed (see Figure IV-1 and Table IV-1). This changing

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2. Civil Service Retirement benefits have been indexed since 1962, though the first automatic increase actually went into effect in 1965.

pattern followed in part from a slowing of the inflation rate and in part from legislation that reduced eligibility and benefits. Thus, while outlays grew by 14.4 percent in 1981, the rate of growth had fallen to 11.4 percent by 1983. On the other hand, the sharp increase in unemployment in 1981 and 1982 combined with the 1982 drop in GNP prevented nonhealth entitlements from declining as a percent of GNP over this period.

The major legislative actions during the 1980-1983 period that restrained the growth in entitlement spending were the Omnibus Budget Reconciliation Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Social Security Amendments of 1983. The combined impact of this legislation reduced outlays for nonhealth entitlements relative to prior law by about 3 percent in 1983. The effects were not evenly distributed, however, with means-tested benefit programs reduced by about 11 percent and non-means-tested benefits--including Social Security--by about 1 percent in 1983.

The 1984-1989 Period

Beginning in 1984, the combined effects of economic expansion, continued relatively low inflation rates, and recent legislation are projected to cause nonhealth entitlement spending to decline as a percent of GNP, falling below 8 percent by 1989. Projected outlays will rise to $418 billion by 1989, however, with Social Security accounting for about two-thirds of the growth in expenditures over the 1984-1989 period.

Most of the projected spending growth is concentrated in the non-means-tested benefit programs, where outlays are expected to rise by slightly more than 6 percent annually through 1989, or slower than the projected growth in GNP. For example, Social Security outlays are projected to increase at an annual rate of almost 7 percent. In contrast, outlays for means-tested benefits are projected to increase by less than 4 percent annually. The most rapidly growing entitlements are the agricultural price support programs, where spending is projected to grow from about $7 billion in 1984 to nearly $18 billion in 1989--a growth rate of almost 20 percent annually.

BROAD STRATEGIES

Although outlays for Social Security and other entitlements are projected to fall as a percentage of GNP and of the federal budget over the 1984-1989 period, expenditures in this area are still expected to grow by

about 33 percent. Three general approaches that might be used to restrain further the growth of nonhealth entitlement spending include: 3/

- o Changing the methods of adjusting benefits for inflation;
- o Altering the way initial benefits are determined; and
- o Restricting program eligibility.

Changing the Methods of Adjusting Benefits for Inflation

Annual COLAs account for almost 60 percent of the projected increase in nonhealth entitlement spending over the next five years; consequently, much attention has been focused on reducing them as a means of holding down spending increases over time. Because COLA limitations affect all beneficiaries of the indexed programs, even relatively small changes can yield substantial savings. 4/ (For a listing of the major indexed benefit programs, see text box on the following page.)

COLA reductions might be implemented in a variety of ways, but two important questions are common to all COLA options. First, how long should the changes be in place? Second, should the changes affect all entitlement programs or only selected ones?

The period over which COLA restraints are in effect can be handled in different ways. For example, the COLA limitations enacted in 1982 for Civil Service retirees under age 62 were implemented only for a three-year period, an action that permanently lowered benefits for those affected.

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3. Any reductions in federal outlays reduce the unified budget deficit, regardless of whether the spending comes from programs financed through government trust funds or from the general government accounts. For example, if Social Security benefits were reduced and payroll taxes remained unchanged, not only would trust fund reserves increase, but also the overall budget deficit would be lowered.

4. The major entitlement programs paying cash benefits that do not have COLAs as part of their statutes are Veterans' Compensation and AFDC. While Veterans' Compensation benefits have been increased through legislation annually since 1974, only three states have increased AFDC benefits by as much as prices have risen since 1970. Food Stamp benefits are raised annually to reflect changes in food prices, although these increases have been delayed several times.

INDEXED BENEFIT PROGRAMS

The major indexed benefit programs are listed below along with the year each program was first indexed, the basis for the annual benefit modification, the measurement period, and the month in which the COLA goes into effect. a/

	YEAR FIRST COLA PAID	MEASUREMENT PERIOD	MONTH PAID IN FY 1984
Programs Indexed to Consumer Price Index			
Social Security	1975	3rd Qu/3rd Qu	January
Railroad Retirement	1975	3rd Qu/3rd Qu	January
Supplemental Security Income	1975	3rd Qu/3rd Qu	January
Veterans' Pensions	1979	3rd Qu/3rd Qu	January
Civil Service Retirement and Disability	1965	Dec/Dec	June d/
Federal Employee Compensation Act	1967	Dec/Dec	April
Public Health Service Officer Retirement	1965	Dec/Dec	May d/
Foreign Service Retirement	1965	Dec/Dec	June d/
Coast Guard Retirement	1965	Dec/Dec	May d/
Military Retirement	1964	Dec/Dec	May d/
Programs Indexed to Federal Pay			
Black Lung	1969	--	February
Special Benefits for Coal Miners	1969	--	February
Programs Indexed to Food Prices			
Food Stamps b/	1971	June/June	October
School Lunch c/	1973	May/May	July
School Breakfast c/	1973	May/May	July
Child Care Food c/	1975	May/May	July
Summer Food Service for Children c/	1975	Nov/Nov	January
Special Milk c/	1975	May/May	July

a. For a more complete listing of programs with indexing features, see Congressional Budget Office, Indexing with the Consumer Price Index: Problems and Alternatives (June 1981) and Congressional Research Service, Indexation of Federal Programs (1981).

b. The specific index is the change in the cost of the Agriculture Department's Thrifty Food Plan.

c. The specific index is the food-away-from-home component of the CPI.

d. The 1984 COLAs in the federal military and civilian retirement programs, under current law, will be paid in May and June, respectively; beginning in 1985, these adjustments are scheduled to be implemented in June and July.

Similarly, an option such as the elimination of the 1985 COLA (Option IV-1) would permanently reduce benefits for current recipients, but the savings would diminish as these beneficiaries died and new beneficiaries replaced them on the benefit rolls. On the other hand, changes such as paying a COLA equal to two percentage points less than the increase in the Consumer Price Index would provide increased savings over time, although these would result largely from cumulative effects on beneficiaries. For example, for persons receiving benefits now and continuing to receive those benefits through 1990, this option would reduce the purchasing power of benefits by about 11 percent in 1990.

Many proposals to limit COLAs would exempt some entitlement programs. Means-tested programs might be exempted in order to protect low-income beneficiaries from reductions in real income. Options with this exemption typically yield between 85 and 90 percent of the spending reductions that would result if all entitlement programs were covered. Some proposed COLA reductions would exempt specific non-means-tested programs--for example, Social Security and Veterans' Compensation--but these exclusions would result in substantially lower savings, since Social Security alone accounts for two-thirds of the annual increase in spending from COLAs.

Many poor people participate in several entitlement programs--for example, they concurrently receive Social Security and SSI benefits. Exempting means-tested programs from COLA reductions would protect these low-income beneficiaries. But other poor people would not avoid adverse effects, because they do not also participate in means-tested programs. To prevent any poor beneficiaries from suffering income losses from COLA cuts, some proposals would affect only those recipients with benefits or incomes above specified levels. Examples include capping the COLAs at the dollar amount received by the average beneficiary, or limiting COLAs only for those with annual incomes above $10,000. Limiting COLAs on the basis of the amount of the benefit would lead to different treatment of individuals with similar total incomes, however, if they received different proportions of their total incomes from the affected programs, or received relatively small amounts from each of several programs. 5/ If the reductions in COLAs were based on total income rather than on benefits, these problems would not arise, but such an arrangement would be hard to

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5. For example, if COLAs were limited in each program only where individuals received over $500 per month, a beneficiary with $500 from each of two programs would be unaffected while another receiving $1,000 from a single program would be awarded a reduced COLA.

implement because no federal agency receives information on the total incomes of beneficiaries.

Efforts to reduce COLAs receive support for several reasons, some technical and some philosophical. A frequently cited technical rationale is to recapture the increase in outlays caused by the overindexing of benefits during the 1978-1982 period that resulted from flaws in the CPI. 6/ Another argument holds that beneficiaries should not have been fully protected from inflation while workers' real wages declined--as in the 1979-1981 period--and that COLA reductions could be used to lower benefits now to restore the balance between the incomes of beneficiaries and workers. 7/ Finally, COLA reductions are sometimes supported because some beneficiaries have higher incomes than the workers who pay taxes that support programs such as Social Security.

COLA reductions are opposed on several grounds in addition to their impact on the incomes of beneficiaries. First, they could distort program design by causing different groups of beneficiaries to be affected differently. Under the Social Security program, for example, the benefit computation procedures are intended to provide approximately the same level of benefits relative to earnings for each successive group of retirees--that is, a constant replacement ratio. Indexing benefits by less than the full increase in prices each year would, however, result in a growing gap between the benefits received by those on the rolls for several years and those newly eligible. (This gap could be lessened if changes were also enacted to slow the growth in benefits for future retirees as discussed in the next section.)

Opponents of indexing changes also point out that COLAs in many entitlement programs have already been either reduced or delayed, and that further reductions may be unwarranted. They argue that new benefit cuts would undermine public confidence in these programs and that other ways to

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6. For more details, see Congressional Budget Office, Indexing with the Consumer Price Index: Problems and Alternatives (June 1981). One source of bias in the CPI--the treatment of mortgage interest rates and new home prices--will be eliminated in 1985 when the CPI for urban wage earners and clerical workers incorporates a rental equivalence measure of housing costs.

7. This concern is reflected in the 1983 Social Security Amendments, which contained a provision that would limit benefit increases to the lower of wage or price increases, if the trust fund reserves become too low.

reduce the deficit should be found. Finally, COLA cuts would generally affect all beneficiaries, not just those who had received the benefits of overindexing.

Altering the Determination of Initial Benefits

Another method for reducing entitlement spending is to modify the way in which initial benefits are set. Many options of this type would produce much larger savings in the long run than in the near term, but even the short-run savings could be significant.

Some examples of this strategy as it affects individuals include reducing the rate at which each year of employment adds to retirement benefits for the Civil Service Retirement program (Option IV-9) or increasing the number of years of earnings included in calculating Social Security benefits (Option IV-5). This strategy could also be extended to the subsidies provided to firms--for example, by reducing the subsidy to lenders under the Guaranteed Student Loan program (Option IV-18), and by reducing the support price for certain agricultural products (Option IV-21).

Moreover, if COLAs are to be reduced, many would argue that changes in the initial benefit formulas are necessary to maintain comparable benefit levels among beneficiary groups becoming eligible in different years. In Social Security, for example, this could be effected by changing the indexing of the benefit formula in a manner similar to the COLA reduction (Option IV-4), or by modifying the calculation of average earnings used to compute benefits, or both. Alternatively, the benefit formula could be modified for future recipients by gradually reducing the percentage of wages replaced.

Restricting Program Eligibility

Entitlement spending could also be reduced by further restricting eligibility. Changes of this type could resemble those enacted in recent years, which included, for example, lowering the maximum income limits for Food Stamp eligibility or increasing the unemployment rate at which extended benefits become available under the UI program. These eligibility restrictions were frequently designed to protect the neediest beneficiaries while reducing overall spending. Possible additional restrictions include eliminating Veterans' Compensation benefits for veterans with low-rated disabilities (Option IV-13) and instituting a two-week minimum waiting period for UI benefits (Option IV-11).

Another approach for reducing benefits--and improving the accuracy of benefit calculations--could be to concentrate greater resources on the eligibility determination process. For example, automation might eventually reduce error rates and administrative costs in the AFDC and Food Stamp programs, but the initial investment of resources in this effort would be substantial.

While some argue that these changes would affect only those individuals who are less in need of assistance and might also reduce work disincentives, others suggest that many of those potentially affected would incur substantial hardship. Savings from these budget options arise from large cuts for relatively few beneficiaries, and might cause serious financial problems for some of those affected while having only a limited impact on overall federal spending.

CONCLUSION

Since the entitlement programs discussed in this chapter account for roughly one-third of unified budget outlays, cuts in their benefits are likely to figure in any effort to reduce the deficit substantially from the spending side. Moreover, because non-means-tested benefit payments to individuals constitute more than 80 percent of total spending in this area, these programs might have to receive particular scrutiny. Spending in means-tested entitlement programs could also be trimmed, as could payments to producers and governments, but the deficit-reducing effect of marginal changes in these programs would be relatively small. The remainder of this chapter describes in greater detail specific applications of the three basic approaches for restraining the growth of nonhealth entitlement spending.

IV-1. ELIMINATE COLAs IN NON-MEANS-TESTED PROGRAMS FOR ONE YEAR

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Social Security and Railroad Retirement	6,400	8,550	8,550	8,400	8,050	39,950
Federal Military and Civilian Employee Retirement and Disability	500	1,750	1,850	1,900	1,950	7,950
Other Non-Means-Tested Programs	410	540	560	570	590	2,670
Offsets in Means-Tested Programs	-190	-250	-250	-270	-270	-1,230
Total	7,120	10,590	10,710	10,600	10,320	49,340

One approach for reducing outlays in entitlement programs would be to eliminate the next cost-of-living adjustment (COLA) in the non-means-tested benefit programs. If these COLAs were skipped in fiscal year 1985, the change would save about $7.1 billion in 1985 and $49.3 billion over five years, with Social Security and Railroad Retirement COLAs accounting for about 80 percent of the total. As benefits were cut in non-means-tested programs, some beneficiaries would have their incomes reduced enough to qualify for means-tested programs, thus increasing spending in the latter category. Although the savings would eventually disappear as beneficiaries die or cease receiving payments for other reasons, large savings would continue to accrue after 1985 because benefits for those affected would be permanently lower as a result of the skipped COLA. Inclusion of the means-tested programs would increase the savings by about $6.6 billion.

Since automatic benefit increases are projected to contribute more than 60 percent of the growth in outlays in these programs, reducing COLAs is a major way to slow spending. Moreover, eliminating the 1985 COLA--projected to be between 4 and 5 percent--would about offset the

overindexation of benefits that occurred between 1979 and 1982 as a result of flaws in the CPI. In addition, many proponents of COLA reductions point out that current beneficiaries receive total benefits well in excess of their contributions, and that this measure would lessen this high rate of return. Finally, by limiting this option to the non-means-tested cash benefit programs, most of the poorest entitlement beneficiaries--recipients of Supplemental Security Income and veterans' pensions--would be protected from losses of income.

Opponents of COLA changes argue that these reductions would come on top of those already enacted and that many low-income beneficiaries would find it difficult to adjust to any further reduction in real benefits. In addition, since Social Security and other retirement benefit programs represent long-term commitments, many argue that changes in these programs should be gradual and should reflect program rather than budget concerns. Moreover, these benefit reductions could undermine the confidence with which beneficiaries, as well current taxpayers, view the resolve of the federal government to keep its commitments.

Alternatives to the total elimination of the 1985 COLA would be to delay the benefit increase by three or six months, or to reduce COLAs only for those with benefits above certain levels--for example, a program's average benefit. The former approach has been used frequently in recent years and, since it represents a smaller benefit reduction, would diminish both the advantages and the disadvantages of eliminating the COLA entirely. The latter method has been suggested as a means of reducing federal spending that targets most of its impact on higher-income beneficiaries.

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IV-2. REDUCE COLAS IN NON-MEANS-TESTED PROGRAMS BY A FIXED PERCENTAGE OR A FIXED NUMBER OF PERCENTAGE POINTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Two-Thirds of CPI Increase						
Social Security and Railroad Retirement	2,200	5,350	8,700	12,100	15,300	43,650
Federal Military and Civilian Employee Retirement and Disability	120	830	1,600	2,400	3,200	8,150
Other Non-Means-Tested Programs	140	340	550	760	960	2,750
Offsets in Means-Tested Programs	-65	-150	-240	-350	-440	-1,245
Total	2,395	6,370	10,610	14,910	19,020	53,305
CPI Increase Minus Two Percentage Points						
Social Security and Railroad Retirement	2,700	6,500	10,450	14,550	18,700	52,900
Federal Military and Civilian Employee Retirement and Disability	160	1,050	1,950	2,900	3,950	10,010
Other Non-Means-Tested Programs	180	420	660	920	1,200	3,380
Offsets in Means-Tested Programs	-80	-190	-290	-430	-540	-1,530
Total	2,960	7,780	12,770	17,940	23,310	64,760

Reducing annual cost-of-living adjustments (COLAs) either by some percentage of the CPI increase or by the CPI increase minus some fixed number of percentage points are among the most commonly proposed changes to the current indexing of non-means-tested benefits. The table opposite presents the budget savings from setting annual COLAs through 1989 equal to two-thirds of the CPI increase and equal to the CPI increase less two percentage points. The five-year savings from the two-thirds of CPI increase would be $53.3 billion; the savings from the CPI increase less two percentage points would be $64.8 billion.

COLA reductions would result in significant budget savings, especially if continued over a number of years. While such cuts would lessen the purchasing power of benefits over time, they would impose smaller reductions per affected beneficiary than would other cuts targeted toward fewer beneficiaries that would generate the same savings. In addition, the exclusion of means-tested benefit programs, such as veterans' pensions and Supplemental Security Income would protect many of the poorest beneficiaries from any reduction in real income. By contrast, if COLAs in means-tested programs were also cut, this protection would disappear but savings would increase by about 16 percent.

On the other hand, COLA cuts would affect many low-income families even if veterans' pensions and SSI were excluded, and would result in some increase in the poverty rate, particularly for the elderly. More affluent beneficiaries could also find it difficult to maintain the living standard they had anticipated when they retired, if substantial COLA reductions were in place for a sustained period.

Savings from alternative COLA options may be approximated from the table. For example, reducing COLAs to 50 percent of the CPI increase rather than two-thirds would increase the savings by about one-half. Similarly, COLAs equal to the CPI increase minus one percentage point would yield about one-half of the savings estimated for the CPI increase minus two percentage point option. Such approximations should be viewed with some caution, however, because large sustained reductions in COLAs are likely to be offset by disproportionately larger increases in spending for SSI, veterans' pensions, food stamps, and Medicaid. Moreover, this approach would underestimate the savings slightly because of the compounding effects of the COLA reductions over time. Further, the maximum reduction is set by the projected rate of inflation--less than 5 percent annually over the next five years.

IV-3. END INDEXING OF SOCIAL SECURITY DEPENDENTS' BENEFITS

Saving from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-25	-120	-270	-450	-750	-1,615
Outlays	620	1,500	2,400	3,300	4,100	11,920

NOTE: Budget authority reflects all income to the trust funds, including interest earned on reserves. Thus, options that reduce outlays also allow reserves and interest to increase, thereby resulting in different arithmetic signs for budget authority and outlays.

Under current policy, virtually all Social Security benefits, including those paid to dependents, are increased each year to reflect increases in the cost of living. One way to reduce spending in this program would be to discontinue the indexing of dependents' benefits--that is, the benefits paid to the children or spouses of retired or disabled workers. In survivor families, benefits equal to those that the primary beneficiary would have received would be fully indexed under this option, but the remainder would not. If this proposal were enacted, federal spending would be lowered by about $0.6 billion in 1985 and $11.9 billion over the next five years.

These COLA reductions would decrease some of the difference between the return on contributions received by single workers, two-earner couples, and one-earner couples. Proponents of this approach argue that, as long as the basic benefit is protected from inflation, few families would encounter serious financial difficulties. Moreover, the increased labor force participation of women means that a greater proportion of families will have two persons eligible for primary benefits and therefore will not receive dependents' benefits.

On the other hand, all dependents' benefits would be reduced in real terms--regardless of the family's income--and dependents such as divorced spouses, who are among the poorest of the elderly population, would be adversely affected. Over long periods, the value of these benefits would be substantially eroded, since this option scales the reduction in real benefits to the number of years on the rolls. An alternative for reducing dependents' benefits that might be considered less severe would be to apply an income or means test for receipt of dependents' benefits.

IV-4. LIMIT INCREASE IN THE SOCIAL SECURITY "BEND POINTS"

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	0	-5	-20	-40	-80	-145
Outlays	10	100	200	400	700	1,410

NOTE: See note to table in Option IV-3.

The Social Security benefit formula could be altered to reduce initial benefits for all workers who become eligible in the future, thereby slowing the growth in outlays. For persons becoming eligible in 1984, the basic benefit or Primary Insurance Amount (PIA) is computed under the following formula: 90 percent of the first $267 of the worker's Average Indexed Monthly Earnings (AIME), plus 32 percent of the next $1,345 of AIME, plus 15 percent of the AIME in excess of $1,612. Under current law, the formula's "bend points"--$267 and $1,612--are changed each year to reflect changes in average earnings in the economy. If the rate of increase in the bend points were reduced by two percentage points annually in 1985-1989, more earnings would fall into the lower percent replacement brackets, causing benefits to grow more slowly. This would save about $1.4 billion from Social Security outlays over the 1985-1989 period.

Under this option, the replacement rate--the ratio of benefits to preretirement earnings--for an age 62 retiree who has always earned the average wage would be about 33 percent in 1990 as compared to slightly more than 34 percent under current law. While the replacement rate under the option is still higher than the rate for early retirees who first collected benefits in the late 1960s or early 1970s, it is three percentage points lower than the 1979 peak in the replacement rates received by age 62 retirees.

This option would gradually reduce the proportion of preretirement earnings replaced by Social Security benefits and significantly lessen the projected liabilities of the Social Security cash benefit program. It could be coordinated with some of the cost-of-living adjustment options described earlier, thereby ensuring that both current and future beneficiaries would be affected by benefit reductions. Moreover, increased private pension benefits and real wage growth are likely to result in new beneficiaries who are more able to adjust to benefit reductions than those currently receiving benefits.

Changes in the indexing of the bend points would have effects that are uneven across benefit levels, however. Persons with AIMEs at or slightly above the current law bend points would incur the largest benefit reductions in percentage terms, while those with slightly lower benefits would have much smaller losses. Critics of the option also point out that replacement rates would continue to decrease for as long as the indexing was reduced and that, even after full indexing was resumed, benefits would be permanently reduced. Finally, opponents argue that future benefits need not be reduced now because, with the passage of the Social Security Amendments of 1983, no long-run deficit is projected in the trust funds and, further, future retirees will receive total benefits that are roughly equivalent to the amounts they will have paid in payroll taxes.

IV-5. LENGTHEN THE SOCIAL SECURITY BENEFIT COMPUTATION PERIOD BY THREE YEARS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	0	-5	-25	-50	-95	-175
Outlays	30	100	300	500	700	1,630

NOTE: See note to table in Option IV-3.

Social Security retirement benefits are based on workers' Average Indexed Monthly Earnings (AIME) in employment covered by the system over most of their working lives. At present, the number of years that must be included in the benefit computation formula is determined in part by the year in which the retiree reaches age 62. (For more details see CBO, Financing Social Security: Issues and Options for the Long Run, 1982.) Lengthening the averaging period would generally lower benefits, particularly for early retirees, by requiring more low-earnings years to be factored into the benefit computation. One option, advanced by the Administration in May 1981, would gradually add three years to the AIME computation period, basing it on the year the retiree reaches age 65. This proposal, applied to persons turning 62 beginning in January 1985, would save $1.6 billion over the next five years.

Those who favor a longer computation period argue that the number of years included in the calculation of AIME should be based on the age of eligibility for full benefits, not for reduced early-retirement benefits. Moreover, the longer averaging period would reduce incentives for early retirement. Finally, lengthening the averaging period would reduce the advantage that workers with fluctuating earnings have over those with relatively smooth earnings histories.

Opponents of this proposal view it as a means of hiding benefit reductions behind a technical change in the way benefits are calculated. They also argue that, because many beneficiaries elect early retirement for such reasons as poor health or unemployment, a longer computation period would reduce benefits for those recipients who are least able to continue working. Other workers who would be disproportionately affected include women who stop or interrupt their careers to bear and raise children and workers who experienced long periods of unemployment.

IV-6. ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGED 62-64

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-5	-15	-35	-70	-120	-245
Outlays	50	200	375	625	700	1,950

NOTE: See note to table in Option IV-3.

Unmarried children of retired workers are eligible for Social Security dependents' benefits as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. The child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64 beginning with retirees reaching age 62 in October 1984, the savings would total about $1.95 billion over the next five years. About 150,000 beneficiaries annually would be affected under this proposal.

This option might encourage some retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger workers are, the more likely they are to have children under 18 years old; thus, there may be an incentive now for workers under age 65 to retire while their children are still eligible for benefits. This effect is likely to be quite small for many families, however, since the increase in a household's total benefits attributable to eligible children would be quite limited.

On the other hand, for families with workers who retired because of poor health or unemployment and received reduced retirement benefits, the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 receive benefits, elimination of children's benefits for families of early retirees would also result in the loss of the spouse's benefit in some families. In such families, the total loss of income could be significant.

IV-7. TIGHTEN LIMIT ON FAMILY BENEFITS FOR OASI RECIPIENTS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	-5	-20	-45	-85	-140	-295
Outlays	75	250	450	680	950	2,405

NOTE: See note to table in Option IV-3.

Currently, the two Social Security cash benefit programs--Old Age and Survivors Insurance (OASI) and Disability Insurance (DI)--have different limits on maximum family benefits: the limits are stricter for families of disabled workers than they are for families of retired workers or survivors. Under current law, the maximum DI family benefit is the lesser of 85 percent of the worker's Average Indexed Monthly Earnings (but not less than 100 percent of the Primary Insurance Amount) or 150 percent of the worker's PIA, whereas the OASI family maximum ranges from 150 percent to 188 percent of the PIA. If the DI limit were extended to all newly eligible OASI beneficiaries beginning in October 1984, the 1985-1989 savings would total about $2.4 billion.

Use of a common maximum family benefit for the two programs would eliminate certain anomalies that exist under the current system. For example, the family of a disabled worker under present law can receive an increase in total benefits when the disabled worker reaches age 65, because at that age the person would become an "old-age" beneficiary instead of a "disability" beneficiary. Also, an early retiree who is married and has a child under 16 can receive more in family benefits than a similar disabled worker. Extending the DI maximum to OASI families might also encourage greater work effort from persons who might otherwise retire early.

Lessening the maximum family benefit could, however, significantly reduce benefits for some families who have few other sources of income. To change the benefit structure without much warning could result in hardship for some of them. Moreover, the change would reduce benefits more for families with low basic benefits than for those with higher benefits, thereby reducing the progressivity in the current benefit structure.

IV-8. INCREASE THE WAITING PERIOD FOR SOCIAL SECURITY DISABILITY INSURANCE BENEFITS TO SIX MONTHS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	-20	-35	-45	-55	-75	-230
Outlays	150	160	160	170	180	820

NOTE: See note to table in Option IV-3.

Disabled workers now are required to be continuously disabled for five months before they are eligible for Social Security Disability Insurance (DI) benefits. In addition, the disability must be expected to last at least one year or to result in death. If the waiting period were increased to six months--the length before 1972--for workers becoming eligible beginning in October 1984, the five-year savings would amount to about $0.8 billion.

This change would make DI eligibility rules conform to other Social Security provisions, as well as to many private disability plans. For example, Social Security payroll taxes must be paid on the first six months of sick pay. Moreover, many individuals eligible for DI benefits do not apply for these benefits until after six months of disability have passed, but do receive a retroactive payment for that sixth month anyway. In addition, since the Supplemental Security Income (SSI) program has no waiting period requirement, the poorest of the disabled could rely on that program's benefits.

While such a change in the waiting period might not substantially disadvantage disabled workers with other sources of family income, many eligible individuals have no other income, so the loss of one month's benefits might be excessively burdensome, especially for those whose assets exceed the limits for SSI eligibility. Also, since the definition of disability is very strict, it is unlikely that a longer waiting period would reduce the number of applicants.

IV-9. MODIFY CIVIL SERVICE RETIREMENT PROVISIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	800	1,500	1,600	1,500	1,400	6,800
Outlays	260	930	1,150	1,350	1,560	5,250
Revenue Loss	-800	-800	-800	-600	-600	-3,600
Net Savings	-540	130	350	750	960	1,650

Benefits under the Civil Service Retirement (CSR) system, covering 2.7 million active workers and 1.8 million annuitants, are large compared with the benefits private-sector workers typically receive from employer-provided plans coupled with Social Security. Private-sector practice will likely serve as a model in designing pension benefits for new federal workers who have recently been brought under Social Security. Some favor reducing benefits and mandatory employee contributions for current federal workers as well. The following CSR modifications would not reduce benefits already earned, but would bring CSR costs for future service closer to those of the private sector.

- Reduce employees' CSR contribution rate from 7 percent of salary to the non-Medicare rate for Social Security--5.7 percent now, but increasing to 6.06 percent in January 1989.

- Reduce the CSR benefit accrual rate for service after October 1984 from its current 2 percent of average final salary for each year of service to 1.67 percent.

- Continue to apply the existing retirement age and length of service criteria (such as age 55 with 30 years of federal service) but reduce benefits earned after October 1984 by 2 percent for each year a person retires before age 62.

- Provide annual cost-of-living adjustments (COLAs) each January but only half COLAs for CSR income that exceeds $1,000 per month in 1984 dollars. (This change would limit the size of COLAs on benefits earned before and after 1984.)

The budgetary savings from these changes would occur mainly beyond 1989. But the government's out-of-pocket costs in 1989 would fall by $960 million, mainly reflecting $1,470 million in outlay savings from smaller COLA costs partly offset by a $600 million revenue loss from reduced employee contribution rates. (For estimating purposes, CBO assumes no change in the 7 percent of pay contributed by federal agencies for CSR benefits.)

Modifying CSR for current employees, proponents argue, could help minimize differences between the value of retirement benefits earned by current workers and newly hired workers. Without this equity, work-force morale could suffer as the percentage of federal workers with CSR coverage declines. Proponents also point out that the modifications would help reduce the two most costly elements of the CSR system--the COLA provisions and the availability of a full annuity at age 55.

Opponents of these changes respond that cutting pension benefits is especially unfair given the increasing number of private-sector employers who supplement pensions with stock options, thrift plans, and other types of deferred benefits that are not available in federal jobs. Moreover, federal employees might feel that pension cuts would breach a moral contract that has linked a generous pension to salaries held below market rates. Regardless of how expensive the CSR system has become, some would contend that until the dimensions of the federal pension plan for new workers are known--probably not until 1985--it is premature to adjust CSR for existing workers.

Alternatively, some critics maintain, particularly because of the proposed reduction in employee contribution rates, that even a modified CSR system would still be too expensive. If so, the Congress might consider increasing the 7 percent employee contribution rate to 8 percent or offsetting a portion of the CSR annuity for "retirees" who work and earn more than $7,000 per year, similar to the Social Security earnings test. Such changes might yield 1985 savings of $600 million and $200 million, respectively.

IV-10. INDEX THE UNEMPLOYMENT INSURANCE TAXABLE WAGE BASE

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	240	960	1,850	2,650	3,750	9,450

NOTE: These estimates assume that the change is implemented in 1985 for the federal tax base, but not until 1986 for the minimum state bases (to allow time for changes in state laws). Further, some states with UI programs in good financial condition are assumed to offset increases in the tax base with reductions in their tax rates.

The federal Unemployment Insurance (UI) taxable wage base--which also serves as the minimum base for state UI taxes--is currently $7,000 per worker, and has been increased only three times from its level of $3,000 in 1940. During that period, the proportion of wages subject to the federal tax has fallen from over 90 percent to about 40 percent. In contrast, UI benefits have increased automatically with nominal wages, because benefits are based in part on prior earnings and because many states index their maximum weekly benefit to average weekly wages. Indexing the federal UI wage base by linking it to average earnings in the national economy--as is done with the Social Security base--would increase annual revenues, and reduce the federal budget deficit, by about $9.4 billion over the 1985-1989 period.

This option could help to stabilize the long-term financial position of the UI system by allowing revenue increases to follow the same path as benefit gains. It could also reduce the need for further increases in tax rates--average state UI taxes have increased from 1.3 percent of taxable wages in 1970 to about 2.5 percent in 1982, for example--which tend to have a greater impact on low-wage or high-turnover jobs.

Because this change could result in higher labor costs for employers, however, it might have adverse effects on the level of employment. In addition, mandating increases in minimum wage bases for state UI taxes would limit somewhat the flexibility of states in designing tax systems to finance their UI benefits.

IV-11. REQUIRE A TWO-WEEK WAITING PERIOD FOR UNEMPLOYMENT INSURANCE BENEFITS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	0	0	0	0	0	0
Outlays	0	930	940	970	1,000	3,800

Current federal law imposes no mandatory waiting period before jobless workers can receive their initial Unemployment Insurance (UI) benefit payment. The Omnibus Reconciliation Act of 1980 did, however, require states to adopt a one-week waiting period on regular UI or lose some federal benefits under the extended UI program. Forty-two states now require a one-week waiting period for regular UI benefits; the remaining states have no waiting requirement. If jobless workers were required to wait two weeks before receiving UI benefits, the change would not affect the maximum length of time during which they could collect benefits--for example, a person otherwise eligible for 26 weeks of benefits would remain eligible for that same amount, but the payment period would be weeks 3-28 of joblessness. Benefits would be reduced, however, for those not using the maximum number of covered weeks. If implemented in 1986--after allowing time for states to change their UI laws--this option would cut annual UI outlays by an average of nearly $1 billion during the 1986-1989 period.

This option could significantly reduce the work disincentive of UI by increasing the initial cost of being unemployed, yet it would not greatly affect the program's ability to help the long-term unemployed. Further, if UI outlays were reduced, states could also repay some of the $13 billion in outstanding state UI loans from the federal government.

Because this change would reduce the benefits provided to jobless workers who do not use all of their entitlement, however, it would reduce the income support feature of UI. It would also impose additional federal restrictions on state UI programs, a move some oppose since state UI taxes finance regular benefits. Since UI is an insurance rather than a welfare program, some also maintain that workers are entitled to benefits when they are unemployed and that extending the waiting period would be unjustified.

IV-12. END TRADE ADJUSTMENT ASSISTANCE INCOME BENEFITS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	60	100	100	100	100	460
Outlays	60	100	100	100	100	460

The Trade Adjustment Assistance (TAA) program offers income replacement benefits, training and related services, and job search and relocation allowances to workers unemployed because of import competition. The cash benefits are equal to a worker's state unemployment insurance benefits and are available only after UI benefits are exhausted. If these cash benefits were eliminated, federal outlays would be reduced by $460 million during the 1985-1989 period. In addition, TAA funds for training could be shifted to Title III of the Job Training Partnership Act of 1982 (JTPA), which authorizes a broad range of employment and training services for dislocated workers regardless of the cause of job loss. Since Title III does not provide cash benefits, workers who lose jobs because of foreign competition are now treated more generously than other dislocated workers. (See CBO, Dislocated Workers: Issues and Federal Options, July 1982.)

The rationale for this proposal is to secure equivalent treatment under federal programs for all workers permanently displaced from their jobs because of economic shifts. Moreover, extended income replacement benefits by themselves might create disincentives to finding new employment.

One potential drawback to this proposal is that it might cause economic hardship for some long-term unemployed persons--especially those who exhaust their regular UI benefits while enrolled in a training program. This impact could be offset if funds set aside for employment services under TAA that were redirected to Title III of JTPA were used to provide extended cash benefits to workers in training programs under this title.

IV-13. ELIMINATE VETERANS' COMPENSATION PAYMENTS FOR THOSE WITH LOW-RATED DISABILITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	1,250	1,300	1,350	1,400	1,450	6,750
Outlays	1,150	1,300	1,350	1,400	1,450	6,650

Veterans' disability compensation provides cash benefits to veterans with service-connected disabilities based on the degree of their impairment. By eliminating veterans' compensation for those with disability ratings below 30 percent, federal outlays would be reduced by about $1.15 billion in 1985. Almost 1.3 million persons, or about 56 percent of the veteran beneficiaries, would lose their cash benefits--currently $62 to $114 per month--but retain their eligibility for medical care and other associated benefits. In addition, the dependents' allowances currently paid to those with 30 percent or higher ratings could be limited to those with ratings of 50 percent or higher, thereby saving an additional $110 million in 1985.

Veterans' disability ratings were originally designed to compensate for an average loss of earning power, without regard to financial need. With the improvements in reconstructive and rehabilitative medicine, however, proponents of this option question whether those with impairments rated below 30 percent suffer reductions in their earnings as a result of their low-rated disabilities. Many of these persons are compensated for impairments such as moderately flat feet, mild gastrointestinal ulcers, or one partially amputated finger, which may not affect work capability at all. Likewise, dependents' allowances for those with 30 or 40 percent disability ratings probably are not needed for income support. Consequently, this option would target benefits on the neediest of the disabled veterans and their families. It would also result in more comparable treatment of disabled veterans and recipients of disability benefits from other programs.

Opponents, however, view the periodic payments as indemnity payments owed to veterans disabled to any degree while serving in the armed forces. Moreover, current beneficiaries would experience some reduction in their standard of living, whether or not the payments made up a significant portion of their income.

IV-14. REVISE TREATMENT OF LUMP-SUM ADDITIONS TO INCOME IN ASSISTANCE PAYMENTS PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	35	50	50	50	50	235
Outlays	35	50	50	50	50	235

Lump-sum additions to income--such as bequests or retroactive disability benefits--now do not fully offset Aid to Families with Dependent Children, Supplemental Security Income, and Food Stamp benefits. Also, these programs treat lump sums quite differently. In SSI, a lump sum may offset only the current month's benefit due; in AFDC, it may offset future as well as the current month's benefits; or, if unspent, it may disqualify food stamp or SSI recipients by raising assets above program limits. Moreover, none of these programs consistently attempts to recover overpayments of benefits from those who leave the program, although states may do this in AFDC.

One alternative for fully offsetting lump-sum additions to income in benefit levels, and for standardizing their treatment among programs, would be to handle the lump sum as if it replaced each month's usual cash benefits. For example, if an AFDC or SSI recipient normally received benefits of $100 a month, a lump sum of $500 would be treated as if it replaced five months' benefits. Food stamps could be handled similarly, although to avoid double-counting the same lump sum for recipients of both food stamps and a cash benefit, the Food Stamp program would have to make some special allowances for lump sums to AFDC and SSI recipients. If some provision for recouping overpayments from those leaving the program were also made, this option would save $235 million over the 1985-1989 period.

Such a change would conform the treatment of unearned monthly and lump-sum income. It would also make the treatment of beneficiaries more uniform across programs; AFDC recipients who receive lump-sum additions to income now lose much more in benefits than do food stamp or SSI recipients except SSI recipients receiving retroactive Social Security payments. This change might, however, discourage recipients' relatives from contributing to their expenses. It might also encourage recipients not to report gifts or inheritances they receive.

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IV-15. REQUIRE WITHHOLDING OF CHILD SUPPORT ENFORCEMENT PAYMENTS FROM WAGES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	5	25	35	40	40	145
Outlays	5	25	35	40	40	145

The Child Support Enforcement (CSE) program provides support to the states in establishing and collecting child support payments from absent parents. Under current law, states may require employers to withhold child support payments from the wages of absent parents who are delinquent in paying support, but not all states do so. Making wage withholding mandatory would probably increase child support collections by at least 10 percent. This would directly help families not in the Aid to Families with Dependent Children program. AFDC families would not gain from mandatory withholding since the collections would be used to offset AFDC benefits, but the federal government would save $25 million to $40 million a year.

Under current law, only a minority of children with absent parents receive support payments, and this contributes significantly to poverty. In 1982, only 40 percent of poor families with an absent parent had been awarded child support payments. Among those with awards, 39 percent did not receive any payment, and many others received only partial payments. Moreover, court-ordered payments averaged only $2,050 a family. Requiring wage withholding would improve the financial positions of many low-income families, but the majority of them would be unaffected because they have not been awarded child support payments.

Opponents of mandatory wage withholding point out that requiring specific enforcement techniques might violate states' rights. Moreover, some noncustodial parents argue that such withholding would deprive them of one of their most effective means of ensuring visits with their children.

IV-16. REQUIRE STATES TO CONTRIBUTE TO FOOD STAMP BENEFITS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	1,000	1,100	1,100	1,150	1,250	5,600
Outlays	1,000	1,100	1,100	1,150	1,250	5,600

Unlike benefits in other public assistance programs such as AFDC that are funded jointly by the federal government and the states, food stamp benefits are entirely federally funded. As in AFDC, however, the program is administered by state and local agencies, and total spending for benefits varies considerably from jurisdiction to jurisdiction. One way to reduce federal costs for food stamps would be to require states to provide some matching funds in order to be eligible for federal funds. If the states provided 10 percent of total benefit costs, federal food stamp costs would be reduced by about $5.6 billion over the next five years.

A required state match in food stamps might both improve states' administrative efficiency and help to spread the burden of welfare costs more evenly among states. Under the present method of funding benefits, error rates in the Food Stamp program are relatively high when compared with other programs such as AFDC, and proponents of this option argue that states would have more incentives to hold down costs if they were required to pay some part of them. In addition, some states may provide low benefits under AFDC and SSI because they count on food stamps, which they do not pay for, to raise total benefits to more acceptable levels. Requiring states to share a proportion of food stamp costs might reduce incentives to hold cash benefits at low levels, since the advantages to states of such cost-shifting would be reduced.

On the other hand, requiring a state match in food stamps would impose additional fiscal burdens on states. It might also encourage some states to reduce eligibility and benefit levels in other welfare programs to try to hold down their total welfare expenditures. Further, other approaches, such as error rate sanctions like those implemented in the Medicaid program and allowed in AFDC under the Tax Equity and Fiscal Responsibility Act of 1982, might be more effective in reducing food stamp error rates than would a relatively low state matching rate.

IV-17. REDUCE THE SUBSIDY FOR NONPOOR CHILDREN IN THE CHILD NUTRITION PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	260	270	280	290	310	1,410
Outlays	260	270	280	290	310	1,410

The child nutrition programs, the largest of which is the National School Lunch program, provide cash and commodity assistance to schools and other institutions that serve meals to children. In the National School Lunch program, for example, most schools receive $1.20 in cash reimbursement for each meal served to children from households with incomes below 130 percent of the poverty line, and lunches are served without charge to these children. The subsidy for lunches for children from households with incomes between 130 percent and 185 percent of the poverty line is 80 cents per lunch; for children with household incomes above 185 percent of the poverty line, it is 12 cents. Comparable three-tiered reimbursement schedules are used in the School Breakfast program and in a portion of the Child Care Feeding program. Schools receive commodity assistance in addition to cash assistance for all meals served.

Eliminating the cash reimbursement for meals served to children from households with incomes over 185 percent of the poverty line (about $18,850 per year for a family of four in 1983, for example) would reduce federal expenditures by about $260 million in 1985, and about $1.4 billion over the 1985-1989 period. Savings would depend in part on the extent to which schools chose to drop out of the program--with lower total subsidies, some might judge that the federal reporting requirements and restrictions on meal composition were too burdensome to make participation worthwhile, especially if few children remained eligible to participate in the program.

Proponents of this option argue that this change would result in better targeting of nutrition assistance to those most in need. Opponents argue that meals qualifying for reimbursement are nutritionally superior to those from alternative sources, and eliminating subsidies for nonpoor students could result in lower-quality meals. Further, if institutions dropped out of the program, all children--including the poor--would be denied the benefits of free and reduced-price meals.

IV-18. REDUCE THE SUBSIDY FOR GSL LENDERS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	-30	110	110	100	100	390
Outlays	0	110	110	100	100	420

In the Guaranteed Student Loan (GSL) program, the federal government subsidizes lending institutions that provide student loans. The yield on these loans varies with interest rates, giving lenders 3.5 percentage points above the bond equivalent rate for 91-day Treasury bills. These loan subsidies may be higher than necessary to induce lenders to participate in the GSL program because the federal government bears all risk of rising interest rates and insures the loans against defaults. Currently, some lenders bill the government for interest on the full amount of a loan, even when the loan is disbursed to the student in more than one payment. Federal costs could be reduced by requiring that lenders disburse loans made at the beginning of the school year in two payments and pay interest only on the amount disbursed. This change would reduce federal spending by $420 million between 1985 and 1989, assuming that loan volume does not decline.

One alternative for reducing the current subsidy would be to reduce the yield on loans while students are in school because lenders' costs of administering loans are lower during this time. Each half-percentage-point reduction in the yield on new loans would reduce spending by $285 million during the next five years.

Another alternative would be to determine yields through a market mechanism. Lenders could be required to bid for loans in a manner similar to auctions for government securities. It is not certain how strong the effect would be, but each half-percentage-point reduction in the yield on new loans would reduce outlays by $350 million in 1985-1989. For each half-percentage-point reduction, savings from this approach are higher than for the first alternative because the yield would be lower during the entire life of the loan, not just while the borrower was in school.

Reduction in the current subsidy could cause some lenders to stop providing GSLs, however, and thus make loans more difficult for students to obtain. Increased program complexity, particularly under the auction alternative, might also reduce loan availability. The effect would probably differ across the country, depending on how local lenders responded.

IV-19. REDUCE STUDENT LOAN DEFAULT COSTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	95	110	110	110	110	535
Outlays	95	110	110	110	110	535

The federal government protects Guaranteed Student Loan (GSL) lenders against defaults by reinsuring state guarantee agencies, who must first insure lenders. Because large numbers of borrowers are entering repayment status, federal default costs are increasing. Default costs were about $300 million in 1982, $500 million in 1983, and are now expected to equal $600 million in 1989. Two options could be implemented jointly to reduce federal costs by $535 million during the next five years. They are: more strictly enforce current "due diligence" provisions that lenders must follow when collecting loans, and restore a previous coinsurance provision that required state agencies to pay a portion of all default costs.

These options would reduce federal costs by increasing lenders' and states' efforts to prevent defaults. The coinsurance would give state agencies a monetary incentive to lower defaults and would directly reduce federal costs.

Some lenders or state agencies might, however, drop out of the program, thereby making GSLs more difficult to obtain. Or states might shift some of their default costs to students--including students who will not default--by increasing the insurance premiums that students pay when obtaining loans. In addition, rigid application of due diligence might cause difficulty for borrowers unable to obtain jobs after leaving school. Such needy students could, however, renegotiate their loan payments based on their current situations.

IV-20. ELIMINATE THE EARNED INCOME TAX CREDIT

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Outlays	30	940	920	870	800	3,560
Revenue Gain	10	260	220	180	170	840
Total Savings	40	1,200	1,140	1,050	970	4,400

The Earned Income Tax Credit (EITC) provides cash supplements through the personal income tax system to working parents with relatively low earnings. A refundable tax credit is available to families with children and gross incomes of less than $10,000. The credit, which was last modified by the Revenue Act of 1978, is 10 percent of earnings, limited to $500 for those earning between $5,000 and $6,000, and declining to zero at $10,000 of earnings. About 6.7 million families received the credit in 1981, and average annual benefits were about $285. If the credit were eliminated starting in January 1985, savings for the 1985-1989 period would be $4.4 billion.

The rationale for the EITC was to aid families with very low earnings and to encourage work effort from those whose potential earnings were low. Critics of the credit argue that its effects on work incentives are probably small since most recipients receive relatively low benefits as a lump sum at the end of the year, and many likely do not know when they make their work decisions what the impact of those decisions will be on their eventual benefits. For some of those with earnings between $6,000 and $10,000--the majority of recipients--the incentive effect of the credit may even be negative, with lower EITCs and higher taxes offsetting a significant part of the higher earnings. To the extent that workers can control their hours, therefore, it may encourage some to work fewer hours than they otherwise would in order to retain as much of the credit as possible.

For families with earnings under $6,000, however, the EITC may help to offset some of the work disincentives that affect earners participating in programs such as AFDC and food stamps. In addition, the EITC is the only benefit aside from food stamps for which most of the working poor are eligible, and it does aid over 6 million families. Supporters of the credit argue, therefore, that if, instead of being eliminated, the credit were expanded or at least restored to 1978 levels in real terms, both the work incentives it provides and its aid to the working poor would be increased.

IV-21. REORIENT AGRICULTURAL COMMODITY PRICE SUPPORT POLICY

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	0	7,750	9,000	10,600	13,600	40,950
Outlays	0	7,750	9,000	10,600	13,600	40,950

To protect the incomes of U.S. farmers, current policies raise the prices of wheat, corn and other feed grains, rice, and most U.S.-grown cotton to levels appreciably higher than these commodities would command without government intervention. If overall federal policy were altered to emphasize year-to-year stability in commodity prices rather than higher long-term levels, a reduction of 60 percent in total farm-price-support outlays could be effected. Three key features would characterize such a shift: price supports and ceilings that changed in response to shifting market conditions; less reliance on the government stockpiling of surpluses; and elimination of so-called "deficiency payments," which compensate farmers when crop prices fall. If first applied for the 1985 crop season, annual outlay savings over the 1986-1989 period would average $10.2 billion, producing cumulative savings of nearly $41 billion by the end of 1989.

The main criticism of such a reorientation of farm policy is the potential exposure to income reductions to which farmers would be subjected. Farmers who have invested in land at prices reflecting federal supports would suffer particularly adverse affects.

Spokesmen for such a reorientation, however, note that price supports have led to massive commodity surpluses that end up as government-held stockpiles, the maintenance and distribution of which entail budgetary costs. They would also point to the tendency of price supports to depress export sales. Short-term loss of farm income could ultimately be offset by an improved position in export markets resulting from more competitive prices. Finally, as current price-support benefits tend to be dispensed in proportion to farms' output, large-scale, more-affluent farms with the greatest production stand to benefit most; reoriented farm policy could permit improved targeting of federal assistance toward less-prosperous farm families.

IV-22. ELIMINATE THE HONEY PRICE SUPPORT PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	0	40	40	40	40	160
Outlays	0	40	40	40	40	160

Honey producers' incomes are supported through government loan and purchase activities. For the past several years, the price support loan has been set at 60 percent of the honey parity price--the minimum required by law. Prior to the 1981 honey marketing year, market prices remained above the loan rate and, while there was loan activity, the government acquired very little honey. Since 1981, however, the support price has increased to the point where it exceeds average market prices. As a result, the government has acquired nearly 65 million pounds of honey, about 25 percent of annual use. In 1983, outlays were $60 million. If the program were eliminated after the 1984 marketing year, the government would save $160 million over the 1986-1989 period.

The price support program results in higher prices not only for domestic producers but also for foreign producers. About 240 million pounds of honey are produced annually in this country--about 90 percent of domestic consumption. But imports have nearly doubled since 1980 in response to higher support price levels. Imports more than fill the deficit between domestic production and consumption; the excess supplies are acquired by the government. Honey imports are not subject to import quotas and bear only a small duty.

Elimination of this program would benefit consumers by allowing prices to fall below support levels and would lower U.S. imports of honey. But domestic producers would suffer some loss of income from lower prices.

IV-23. ELIMINATE THE WOOL AND MOHAIR PAYMENT PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	0	130	140	150	160	580
Outlays	0	130	140	150	160	580

The National Wool Act of 1954 authorized payments to farmers on marketings of shorn wool, unshorn lambs, and mohair. Payments are at a rate approximating the difference between the support price and the national average price received by farmers. The program was enacted as a measure of national security and general economic welfare, because shorn wool was considered an essential and strategic commodity. The objective was to encourage annual domestic production of 300 million pounds of shorn wool. Eliminating the wool and mohair payment program at the end of the 1984 marketing year would save $580 million in 1986-1989.

About $1.5 billion has been paid to farmers since the inception of the program; the amount in 1983 was $82 million. Even so, domestic wool production has declined by more than half since 1954 and is now about 100 million pounds a year. The program has had little effect on wool production because decisions to raise sheep are based mainly on the prospects for selling lambs as food. Moreover, the use of synthetic fibers has grown, replacing some wool demand.

Elimination of this program would have only a small impact on most producers. Producers' annual cash receipts from the sale of wool and mohair would decline by about 40 percent, but producers receive about 80 percent of their receipts from the sale of sheep and lambs. Federal payments are only about 10 percent of producers' total cash receipts--an average of $1,200 per farmer, with two-thirds of the producers receiving payments of less than $200. Thus, eliminating payments would have small effect on most producers. Some producers might, however, experience significant losses.

IV-24. LIMIT GENERAL REVENUE SHARING TO JURISDICTIONS EXPERIENCING FISCAL DISTRESS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	1,350	1,350	1,450	1,500	1,600	7,250
Outlays	1,050	1,350	1,450	1,500	1,550	6,900

The General Revenue Sharing (GRS) program, established in 1972, provides unrestricted grants totaling $4.6 billion annually to units of local government. State governments also participated until 1981, when their share was eliminated on the ground that their fiscal condition no longer warranted general federal support. A similar strategy could be used to maintain funding only for fiscally pressed local governments, ending funding for those in strong condition. A 30 percent reduction in program funding would save $6.9 billion over the 1985-1989 period.

Eligibility for GRS could be restricted in numerous ways. Local governments with either below-average tax effort or above-average capacity to support services, or both, could be eliminated. Alternatively, state governments could be invited to submit proposals for identifying distressed communities and for distributing aid among them.

One argument for eliminating GRS for well-off jurisdictions is that under current circumstances federal aid should be focused on areas with the least capacity to help themselves. Further, GRS payments represent less than 2 percent of local governments' total revenues.

On the other hand, the formula determining GRS allocations takes into account jurisdictions' fiscal condition, so that better-off jurisdictions already receive less than other localities. Also, over the last decade, GRS has been integrated into the budgets of its recipients, and ending that support could place at least temporary stress on some governments.

CHAPTER V. NONDEFENSE DISCRETIONARY SPENDING

Many nondefense programs are considered "discretionary," in that the law establishes no entitlement to benefits from them. The Congress exercises its discretion on setting spending levels for these programs through the appropriations process, either by appropriating budget authority or by establishing loan limits, expenditure limits, or obligation ceilings. Nondefense discretionary programs fall into six broad subcategories (also detailed in the text box that follows):

- o Assistance to business and commerce,
- o Benefits and services to individuals,
- o Transportation, natural resources, and other infrastructure,
- o Research and development,
- o Aid to foreign governments and international organizations, and
- o Federal government operations.

In fiscal year 1983, total nondefense discretionary spending came to $156 billion: $144 billion, or 18 percent of unified budget outlays, plus another $12 billion in off-budget outlays. About one-third of the on-budget spending for nondefense discretionary programs goes for benefits and services to individuals, and almost 30 percent goes for transportation, natural resources, and otner infrastructure-related undertakings. Research and development and federal government operations account for most of the remainder.

Overall, more than half of 1982 nondefense discretionary spending went either to states and localities or to the federal work force. About 35 percent of on-budget nondefense discretionary spending--$48 billion--was disbursed as grants to state and local governments. Federal pay and agency contributions for employment benefits for current government employees in nondefense agencies totaled about $33 billion in 1982. The remainder went directly to individuals, businesses, or foreign governments in the form of loans, grants, or purchase of goods and services.

SUBCATEGORIES OF NONDEFENSE DISCRETIONARY SPENDING

Assistance to Business and Commerce. Includes federal support for specific businesses and industries--such as low-interest loans to farmers from the Farmers Home Administration (FmHA)--as well as general aid to commerce. Major on-budget activities include subsidy payments to the Postal Service and programs of the departments of Agriculture and Commerce, the Government National Mortgage Association (GNMA), the Small Business Administration (SBA), and the Export-Import Bank (Eximbank). Rural Electrification Administration (REA) programs, credit activities, and the Strategic Petroleum Reserve (SPR) account for large off-budget expenditures. (See Options V-1-5.)

Benefits and Services for Individuals. Includes housing, education, employment and job training, health services, legal aid, veterans' hospitals, and assistance in paying energy costs. (See Options V-6-14.)

Transportation, Natural Resources, and Other Infrastructure. Encompasses the construction, operation, management, and maintenance of the nation's physical resources--including the major transportation systems, pollution control facilities, forests, parks, and other public lands, water, mineral and other natural resources, and community development projects. (See Options V-15-26.)

Research and Development. Includes aeronautical and space activities of the National Aeronautics and Space Administration (NASA), health research (mostly under the auspices of the National Institutes of Health), nondefense research by the Department of Energy, and research programs of the National Science Foundation (NSF) and the departments of Agriculture and Education. (See Options V-27-31.)

Aid to Foreign Governments and International Organizations. Includes all economic and military assistance to foreign governments, contributions to international organizations, and international monetary programs. Outlays for foreign military sales credits appear off-budget. (See Optionls V-32-33.)

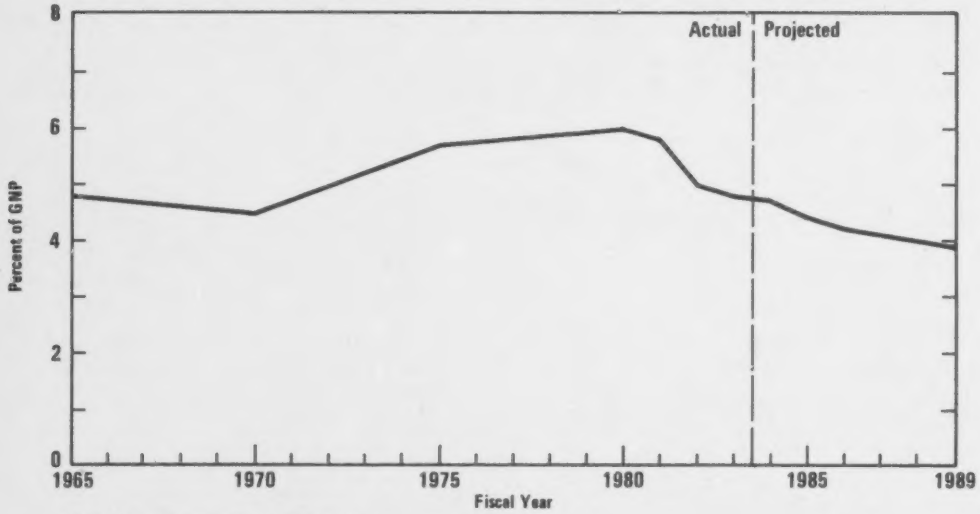
Federal Government Operations. Encompasses basic activities of the federal government, including the conduct of foreign affairs, the Coast Guard, the administration of the Social Security and Medicare programs, law enforcement, judicial, and regulatory activities, the operations of Legislative Branch agencies, and the Internal Revenue Service. (See Options V-34-36.)

HISTORICAL TRENDS

Measured as a percent of the gross national product, outlays for nondefense discretionary programs (including off-budget items) changed only slightly between 1965 and 1983, representing 4.7 percent of GNP in 1965 and 4.8 percent in 1983. Between those dates, however, significant changes occurred. As shown in Figure V-1, spending in this category dropped to 4.5 percent of GNP by 1970, rose to 6.0 percent by 1980, and declined rapidly to 4.8 percent in 1983. Average annual outlay growth was about 13.2 percent (in nominal terms) between 1970 and 1980, slowing to 8.3 percent in 1981. Outlays for this category fell by 8.6 percent in 1982, to $154 billion, $1 billion below the 1980 level of $155 billion.

Figure V-1.

Nondefense Discretionary Spending as a Percent of GNP, 1965-1989



SOURCE: Congressional Budget Office.

NOTE: Data reflect five-year intervals 1965-1980 and annual intervals 1980-1989.

Total outlays rose again in 1983, but only by 1.0 percent, to slightly above the 1980 level. More growth is expected for 1984 (see Table V-1), in part attributable to spending increases enacted under the Surface Transportation Assistance Act of 1982 (Public Law 97-424) and the Emergency Jobs Appropriations Act of 1983 (Public Law 98-8). Under baseline assumptions, outlays are projected to grow by about 5 percent annually over the 1984-1989 period.

TABLE V-1. FEDERAL OUTLAYS FOR NONDEFENSE DISCRETIONARY SPENDING
(By fiscal year, in billions of dollars)

Subcategory	Actual 1980	Actual 1983	Estimated 1984	Baseline Projection 1985	1986	1987	1988	1989
Assistance to Business and Commerce	9	9	8	7	7	8	9	10
Benefits and Services to Individuals	47	48	50	52	55	58	60	63
Transportation, Natural Resources, and Other Infrastructure	44	40	47	46	48	49	51	53
Research and Development	15	17	18	19	20	21	22	23
Aid to Foreign Governments and International Organizations	8	9	10	11	11	12	12	13
Federal Government Operations	18	21	24	24	25	26	27	28
Civilian Agency Pay Raises	a/	a/	1	1	3	5	7	10
Unified Budget Subtotal	141	144	156	161	168	178	189	198
Off-Budget Outlays	14	12	13	13	13	14	13	13
Total, Unified and Off-Budget Outlays	155	156	169	174	181	192	202	211

SOURCE: Congressional Budget Office.

a. Not applicable.

Though total spending for this category as a percent of GNP was little different in 1983 from what it was in 1965, its composition has changed in a number of ways. Outlays for benefits and services to individuals have risen sharply (from 0.7 percent of GNP to 1.5 percent), while expenditures for research and development and foreign aid have declined (see Table V-2). Most of these changes occurred before 1980, however, and little change in the spending mix has occurred since then.

TABLE V-2. HISTORICAL TRENDS IN NONDEFENSE DISCRETIONARY SPENDING

Subcategory	Average Annual Percentage Change in Outlays				Outlays as Percent of GNP	
	1965-1970	1970-1975	1975-1980	1980-1983	1965	1983
Assistance to Business and Commerce	14.6	16.2	2.9	-0.5	0.3	0.3
Benefits and Services to Individuals	22.4	13.9	14.8	0.3	0.7	1.5
Transportation, Natural Resources, and Other Infrastructure	5.6	10.9	16.8	-1.1	1.3	1.2
Research and Development	-1.0	4.4	11.1	1.9	1.1	0.5
Aid to Foreign Governments and International Organizations	-6.3	9.8	5.0	3.0	0.8	0.3
Federal Government Operations	9.1	13.9	10.2	0.6	0.6	0.7
Unified Budget Subtotal	6.9	11.6	12.6	0.2	4.7	4.5
Off-Budget Outlays	a/	a/	11.4	-2.7	a/	0.4
Total, Unified and Off-Budget Outlays	6.9	13.9	12.5	0.0	4.7	4.8

SOURCE: Congressional Budget Office.

a. There were no off-budget entities before 1973. In 1975, off-budget outlays came to $8.1 billion.

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Since 1965, pay for nondefense federal employees (excluding postal workers) has not changed significantly as a percent of GNP, amounting to approximately 0.9 percent in both 1965 and 1983. Nondefense employment (except in the off-budget Postal Service) grew by an annual average of about 3 percent from 1965 to 1980. From 1980 to 1983, however, employment dropped by about 13 percent.

DEFICIT REDUCTION STRATEGIES

The Congress has a number of possible general strategies for reducing nondefense discretionary spending, and aspects of each may be necessary to achieve substantial savings. One way to reduce net spending is to **curtail program activity** by cutting the amount of federal money provided for loans, grants, services, construction, and other activities. Ideally, such reductions should be targeted toward wasteful, outmoded, or unproductive programs. Legislative actions in the past few years, however, may already have achieved much of the most obvious savings. (On-budget outlays for nondefense discretionary programs in 1984 would be higher by $21 billion, or 13 percent, if spending had been maintained at the 1981 level, adjusted for inflation.)

Reducing remaining spending is therefore a matter of establishing priorities for the use of limited resources, both among programs and among beneficiaries of individual programs. Federal activities could be scaled back or eliminated in instances in which state or local governments or other nonfederal sources might be appropriate alternative providers of funds, where needs are relatively less pressing, or where program delays would be least harmful. By eliminating or decreasing expenditures for less needy governments, businesses, or individuals (for example, Options V-7, V-8, and V-9), individual programs can be targeted toward the most needy beneficiaries.

In some areas of expenditure to nonfederal governments, recipient states and localities are now required to contribute only small shares of program costs or none at all. Another approach to deficit reduction could be to **require sizable new or increased state and local participation**; receipt of federal grants could be contingent on nonfederal matching shares for perhaps as much as half of program costs. This strategy could apply, for example, in the areas of community development, nutrition, employment and training (Option V-11), or transportation (Option V-18). The result would be that any increases in federal funding go only for those services on

which state and local governments place particularly high value. A drawback, however, could be the added fiscal burden on states and localities. Such a policy change would have to reflect the likelihood than any major federal spending reduction could have significant effects on nonfederal governments. In 1982, discretionary grants accounted for about 12 percent of state and local spending. Thus, a 10 percent reduction in federal grants would require states and localities to reduce their own aggregate spending, or raise revenues, by about 1 percent, although the impact might fall unevenly among various regions, states, or localities.

Another strategy is to **increase receipts from beneficiaries,** rather than cut program activity. 1/ The application of "user fees" requires an identifiable user population, a reasonable method for allocating costs, and a workable collection mechanism. Such fees are already used to finance a number of activities, especially in the transportation area, and increases could result in significant budgetary savings (for example, Options V-19, V-23, V-24, and V-25). Receipts can also be increased by raising interest rates on loans (Options V-3 and V-22).

Another source of savings, with program activity not necessarily reduced, is to **constrain federal pay and benefits.** As noted above, such expenditures account for a large portion of nondefense discretionary spending, and limits on federal pay raises and benefits can produce noticeable savings (Option V-35).

Finally, savings can be achieved by efforts to **make federal programs more efficient,** reducing the spending needed to accomplish the same tasks. Efficiency can be improved by lowering the cost of inputs (Options V-5, V-16, and V-17), by better money management, by changes in contracting procedures (Option V-36), and by a number of other methods, some of which require Congressional action. (The President's Private Sector Study on Cost Control has recommended many management improvements that it estimates could result in substantial savings. A joint General Accounting Office and CBO review of the commission's major recommendations will be published separately.)

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1. For further treatment, see Congressional Budget Office, Public Works Infrastructure: Policy Considerations for the 1980s (April 1983) and Charging for Federal Services (December 1983).

POTENTIAL SAVINGS

The relatively small proportion of the total federal expenditures accounted for by nondefense discretionary spending limits the potential savings in this area. Each 1 percent reduction in spending can save only $1.7 billion in 1985. Thus, a 10 percent reduction in all nondefense discretionary outlays would reduce the 1985 deficit by $17 billion (of a total baseline deficit of $208 billion), and a 25 percent reduction would cut the deficit by $43 billion. (The corresponding on-budget savings would be $16 billion and $40 billion, respectively.)

In the short term, furthermore, reductions in appropriations would not be fully reflected in outlay savings, because of the normal time lag between appropriation, obligation, and expenditure of funds. On average, the first-year outlay savings would be only about half of any reduction in appropriations. Thus, an outlay decrease of 10 percent in 1985 would require funding cuts of 20 percent, on average, while a 25 percent reduction would require funding cuts of about 50 percent.

In the long term, though, gradual increases in savings can be attained by restraining growth in nondefense discretionary programs below the rate of inflation. Annual inflation adjustments for these programs are incorporated in the CBO baseline; therefore, holding growth below the rate of inflation would produce outlay savings relative to the baseline. For example, if appropriations and other types of spending limits were frozen for five years at the 1984 level--except for increases already set by law--outlay savings relative to the baseline would be $4 billion in 1985 and would grow to $35 billion in 1989 (see Table V-3). The 1989 savings would represent an 18 percent reduction in nondefense discretionary spending relative to the CBO baseline.

Over the five-year period, each 1 percent annual nominal increase or decrease in funding for this category would result in an outlay change of about $6 billion in 1989. Thus, if funding were decreased by 2 percent a year in nominal terms, 1989 outlays would be $47 billion below the CBO baseline, compared to $35 billion below with a funding freeze. Similarly, if funding were increased by 2 percent per year, outlays in 1989 would be $23 billion below the baseline, a reduction of about 12 percent (see Table V-3).

The projections in Table V-3 clearly indicate that substantial savings in nondefense discretionary programs would require major programmatic changes--either actual spending reductions or at least growth held well below

the rate of inflation, and/or large new or additional receipts from program beneficiaries. Savings can be attained by restraining all areas of spending, by sharply reducing or eliminating specific major programs, or by some combination of both. The remainder of this chapter provides examples of opportunities for savings in particular programs and types of spending.

TABLE V-3. POTENTIAL LONG-TERM SAVINGS FROM LIMITING GROWTH IN NONDEFENSE DISCRETIONARY SPENDING

	Average Annual Funding Change in Nominal Terms (In percents)	1989 Outlays (In billions of dollars)	Reductions Relative to CBO Baseline a/	
			Amount (In billions of dollars)	Percent
CBO Baseline	5	198	--	--
Increase Spending by 2 Percent per Year	2	175	23	12
Freeze Spending at 1984 Levels	0	163	35	18
Decrease Spending by 2 Percent per Year	-2	152	47	24

SOURCE: Congressional Budget Office.

a. Excludes resulting savings in interest on the public debt.

V-1. END DIRECT AND INDIRECT SUBSIDIES TO THE POSTAL SERVICE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
End Direct Subsidies						
Budget Authority	870	900	940	980	1,010	4,700
Outlays	870	900	940	980	1,010	4,700
End Indirect Subsidies						
Budget Authority	20	45	75	110	150	400
Outlays	420	830	1,240	1,490	1,500	5,480
Total						
Budget Authority	890	945	1,015	1,090	1,160	5,100
Outlays	1,290	1,730	2,180	2,470	2,510	10,180

Direct and indirect subsidies to the U.S. Postal Service (USPS) allow postage rates to be set somewhat below the USPS's actual costs. Through appropriations to the USPS, the direct subsidy, called "revenue forgone," transfers to the taxpayer certain costs of postal services for preferred mail users--primarily blind and otherwise handicapped persons, religious and other not-for-profit organizations, small-circulation newspapers, and libraries. Indirect subsidies take the form of partial taxpayer support of USPS retirees' pensions and health-care benefits, which contributions do not fully cover. If both direct subsidies (except those for blind and otherwise handicapped persons) and indirect subsidies were eliminated, the five-year reduction in the federal deficit would accumulate to some $10.2 billion through 1989--$4.7 billion attributable to reduced appropriations and $5.5 billion attributable to larger USPS payments for personnel benefits. The savings estimate for indirect subsidies reflects a four-year phase-in and is limited to the current workforce. In addition, the estimate assumes the USPS would continue to make scheduled payments resulting from past pay raises. (Since the USPS is off-budget, its payments to the government are treated as offsetting receipts, which reduce outlays.)

Opponents of this option would argue that even phased-in elimination of postal subsidies would force mail rates up and volume down. The CBO estimates that, without indirect subsidies, first-class rates to all mailers could eventually increase by roughly 10 percent; if both subsidies were eliminated, the cost of preferred-rate mail could rise by about 50 percent.

Critics would also justify governmental support on grounds that to charge the USPS the full cost of benefits that current law prohibits it from negotiating with labor would be unfair. In addition, the USPS might oppose this option if the estimated full cost of pension benefits doesn't specifically reflect the somewhat special characteristics of the USPS work force, rather than those of all federal workers. It is unclear, however, whether targeting pension costs toward postal workers would raise or lower estimated costs to the USPS.

With both subsidies eliminated and mailers carrying full postal-service costs, however, the USPS would move closer to self-sufficiency. Some analysts suggest that eliminating the subsidies gives the USPS an incentive to lower costs by improving management. Others have observed that direct postal subsidies fail to target federal expenditures toward specific national priorities, encourage "junk mail", and provide unnecessary support to many not-for-profit organizations. Moreover, subsidization may give the USPS an unfair market advantage over competing private-sector firms, leading to overuse of the USPS.

V-2. INCREASE THE SHARE OF PRIVATE FUNDS IN SBA LOAN GUARANTEES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	*	25	75	100	120	320
Outlays	*	25	75	100	120	320

* Less than $2.5 million.

The Small Business Administration (SBA) provides credit to firms unable to secure conventional financing. Under current law, the SBA must guarantee 90 percent of the principal for a loan of $100,000 or less, and between 70 percent and 90 percent for loans exceeding $100,000. A lower maximum level of loan guarantee of 50 percent would shift more of the risk to the banks that issue the loans. The SBA's outlays could be reduced by $0.3 billion over the 1985-1989 period by requiring greater private matching funds for section 7(A) general business loan guarantees.

The current low rate of private risk-bearing gives banks little incentive to scrutinize applicants once they have secured an SBA loan guarantee commitment. Moreover, since SBA-guaranteed loans may be resold by issuing banks, the banks may not be holding the loans when a default occurs--often in the second and third year of a loan. The financial institutions have therefore even less incentive to screen applicants. With greater participation and scrutiny by private institutions, the number and volume of SBA guarantee loans would probably shrink, but the quality of these loans would rise. (Historically, between 20 and 30 percent of these loan guarantees have required SBA repurchase.) Financial institutions would have greater incentives to work closely with recipients to avoid default. This could give the federal government more leverage for its effort. Moreover, it would not affect targeted programs--that is, the minority business, handicapped, and veterans' programs.

On the other hand, a drop in the volume of loan guarantees that would attend the changes outlined above would eliminate many borrowers from the market. Newer firms and firms with little or no credit history would most likely be one category of business most adversely affected, as financial institutions would regard them as the most risky. This category, however, represents only a small portion of all 7(A) loan guarantees.

V-3. RAISE INTEREST RATES ON REA LOANS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	0	65	120	180	240	605
Outlays	0	65	120	180	240	605

To promote rural power and telephone service, the Rural Electrification Administration (REA) disburses $1.1 billion each year in direct loans to electric and telephone cooperatives typically for distribution facilities, and guarantees roughly $4.0 billion in loans for generating plants. The direct loan program subsidizes rural cooperatives by lending money (through the REA's Rural Electrification and Telephone Revolving Fund, or RETRF) at interest rates limited by law to 5 percent or lower. About half of these loans are financed by the sale of assets to the off-budget Federal Financing Bank (FFB), which in turn borrows from the Treasury at prevailing interest rates. The Treasury lent the REA $7.9 billion before REA's programs were financed through the FFB.

The RETRF can make these low-interest loans, in part, because its obligations to the FFB and the Treasury are not due until 1993 or later. The RETRF uses the revenues it will need to meet its Treasury and FFB obligations to cover the cost of interest-rate subsidies. But continuing this practice will deplete the RETRF's resources, necessitating either a cutback in the program, added resources, or defaults on REA obligations.

Changing REA policy to require the Treasury-bill rate on direct loans would end the interest subsidy. The additional funds would also put the RETRF in a position to repay its debt to the Treasury and begin to amortize its principal payments to the FFB. Ending the interest subsidies would reduce off-budget outlays by $605 million over the 1985-1989 period, if the volume of lending remains consistent with current policy.

Because 99 percent of farms now have electricity, one can argue that the aim of these subsidies is already met. But higher interest rates on REA loans could raise power rates modestly in regions served by cooperatives that borrow from the REA.

V-4. END EXIMBANK DIRECT LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	1,850	2,500	2,700	3,000	2,200	12,250
Outlays	200	900	1,700	2,200	2,400	7,400

To help certain U.S. export industries maintain overseas sales, the federally supported Export-Import Bank (Eximbank) lends money at subsidized interest rates to foreign purchasers of U.S. products. In recent years, the U.S. industries benefiting most from Eximbank's subsidized overseas lending have been manufacturers of commercial aircraft and heavy equipment, including power generators. If the Eximbank direct loan program were terminated, outlay savings of $7.4 billion would accumulate over the 1985-1989 period.

Supporters of the program hold that Eximbank's subsidized lending is a necessary response to the sometimes "predatory" policies of foreign competitors offering advantageous financing terms to attract and retain buyers. They would also note that export aid stimulates U.S. employment and promotes technological development.

Critics of Eximbank loans regard them as inappropriate interference in the free market that causes economic inefficiency. Such subsidies give an edge to certain U.S. firms and industries over others not receiving comparable support. In general, opponents would note, export subsidies effect income transfers from taxpayers of lending countries--in this case, the United States--not only to assisted firms but also to foreign buyers. Finally, although jobs stimulation is an advantage imputed to export subsidies, evidence of this effect is not clear when ramifications in unsubsidized industries are taken into account.

V-5. ELIMINATE CARGO PREFERENCE FOR NONMILITARY SHIPMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Total
On-Budget						
Budget Authority	150	150	160	160	170	790
Outlays	150	150	160	160	170	790
Off-Budget						
Budget Authority	70	50	60	70	40	290
Outlays	70	50	60	70	40	290

The federal government provides both indirect and direct subsidies to the U.S.-flag merchant marine--vessels owned and operated by U.S. firms and engaged in international trade. A major form of indirect financial aid is provided through so-called "cargo preference" legislation. These laws require that all U.S. military cargo and one-half of any other government freight be carried in U.S. vessels. Aside from military cargo carriers, most beneficiaries are carriers of bulk cargo, including agricultural exports under the P.L. 480 "Food for Peace" program and other U.S. foreign aid, and oil shipments for the Strategic Petroleum Reserve. Because the average costs to build and operate U.S. vessels are some two to three times those for non-U.S. ships, this guaranteed market increases government shipping costs substantially. Thus, eliminating cargo preference requirements for nonmilitary shipments would reduce federal spending by about $1.1 billion over the 1985-1989 period. (Of this sum, about one-quarter is off-budget, since it is for the Strategic Petroleum Reserve.) The loss of nonmilitary government cargo, however, would force some higher-cost U.S. vessels out of business and would reduce the sealift capacity available to the military on short notice. (All U.S. merchant ships are available for military use in the event of a national emergency.)

To make up the difference in operating costs between U.S. and foreign vessels, the Maritime Administration also provides direct assistance in the form of operating differential subsidies. These subsidies--over $400 million in 1984--are provided under long-term contract. Some vessels receive subsidies under both the cargo preference and the operating subsidy programs. As an alternative to changing cargo preference laws, this double subsidy could be eliminated. This would reduce the operating subsidy by perhaps $20 million a year and $125 million over the 1985-1989 period.

V-6. REDUCE AID FOR RURAL SINGLE-FAMILY HOMEBUYERS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
On-Budget						
Budget Authority	200	100	210	320	450	1,300
Outlays	-35	-35	55	170	290	440
Off-Budget						
Budget Authority	1,050	1,300	1,300	1,350	1,400	6,400
Outlays	1,050	1,300	1,300	1,350	1,400	6,400

In 1983, some 52,000 rural households financed single-family homes with reduced-interest-rate loans from the Farmers Home Administration (FmHA). Reducing the total current volume of these loans by half would lower on-budget federal costs by $440 million over the 1985-1989 period and off-budget costs by $6.4 billion.

An argument for this change is that constrained federal resources should focus on the hardest-pressed households. Although reduced-rate FmHA loans are limited to households with incomes not greater than 80 percent of the area median, recipients are considerably better-off than those receiving aid through other FmHA or Department of Housing and Urban Development (HUD) programs. The average income of FmHA single-family borrowers in 1983 was $12,700--about twice the average income under HUD's largest program. Also, other financing appears available to FmHA borrowers--even those with the lowest incomes. Only 15 percent of rural homebuyers with incomes below $10,000 received FmHA mortgages in 1979.

On the other hand, without this program, housing costs for some rural homebuyers would increase, and other households would be unable to purchase homes. FmHA interest rates are set to limit to 20 percent of income the costs for mortgage principal, interest, tax, and insurance. Households with similar incomes who received conventional financing in 1983 would have paid about half their incomes to buy similar housing. An alternative way to reduce federal outlays but maintain loan levels would be to raise borrowers' housing payments to 25 percent of income. This would raise recipients' housing costs but lower on-budget federal outlays by $1.3 billion over the 1985-1989 period and have little effect on off-budget outlays.

V-7. REDUCE AND RETARGET DEPENDENT-CARE AID

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Revenue Gain	90	930	1,070	1,240	1,440	4,770
Outlays a/	-45	-465	-535	-620	-720	-2,385
Net Savings	45	465	535	620	720	2,385

a. Negative outlays represent increases to the baseline.

The federal government currently provides financial support for dependent care through the Dependent-Care Tax Credit and the Social Services Block Grant (SSBG). The tax credit permits taxpayers to claim a specified percentage of employment-related expenses for care of children under age 15 and certain other dependents. The credit is granted on a sliding scale: 30 percent of up to $4,800 in allowed expenses for individuals with adjusted gross incomes below $10,000, declining gradually to 20 percent for those with incomes above $28,000. The SSBG provides funds that can be used for a wide variety of social services, including day care for children and other dependent people. Federal support could be retargeted toward those most in need--while reducing the deficit--by tightening the tax credit and expanding the SSBG, with the stipulation that the additional funds be used to provide dependent care to low-income families. Eligibility for the tax credit could be limited to families with adjusted gross incomes below $30,000, and half of the savings could be applied to the grant program. The resulting net savings would be $45 million in 1985 and $2.4 billion over the 1985-1989 period.

This option would help meet the growing need for dependent-care services for low-income families. The number of children under six living in poverty is projected to increase by roughly one million during the 1980s (from 3.95 to 4.9 million), and three-fourths of this increase will likely occur in single-parent families headed by a female. The families of these children will have difficulty obtaining high-quality child care without assistance, and because of their low incomes, few of them benefit from the tax credit. (Some low-income families would not even benefit significantly from a refundable credit, because of the long time span between their expenditures and reimbursement through the credit; an advance-payment

option to overcome this could be cumbersome.) This option might also increase work incentives for some low-income parents.

On the other hand, this change would require a partial reversal of some recent changes in federal support for dependent care. In creating the SSBG in 1981, the Congress removed the requirements of the predecessor program (Title XX) that benefits be targeted by income and that a specified amount of funding be spent on child care. This change would also adversely affect some families with higher incomes whose tax liabilities would be raised by the tightening of the tax credit.

V-8. NARROW ELEMENTARY AND SECONDARY EDUCATION AID

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	260	270	290	300	320	1,440
Outlays	20	200	270	280	300	1,070

Federal assistance for elementary and secondary education could be reduced while support of services to students with special needs was increased. The largely untargeted block grants for improvement of elementary and secondary education--the Education Consolidation and Improvement Act (ECIA), Chapter 2--could be eliminated, and a portion of the savings could be allocated to compensatory education for the disadvantaged--ECIA, Chapter 1. With Chapter 2 grants eliminated and one-half of the funds reallocated for compensatory education, outlays would decrease by $20 million in 1985 and $1.1 billion over the 1985-1989 period.

Some would argue that in a time of budgetary stringency, untargeted aid for activities primarily supported by states and localities should have low priority for scarce federal funds. Since Chapter 2 funds are primarily untargeted, many of the districts that would lose the most under this option do not have special needs for federal assistance. Moreover, since Chapter 2 contributes only a small percentage of total school district funds, the effect of its termination would generally be small.

At the same time, this option would provide appreciable additional aid to districts with high concentrations of low-income children and would increase services to low-achieving as well as low-income students. In recent years, while the number of children in poverty has risen, Chapter I funds have not kept pace with inflation. This option would partly offset the decline in real Chapter I funding per student caused by inflation and the increased poverty rate among children.

On the other hand, the Chapter 2 block grant originated in part to free state and local education officials from the restrictions of "categorical" federal programs. Redirecting Chapter 2 funds into the Chapter 1 program would reinstate some federal constraints in the use of federal funds. It would also, of course, diminish total federal spending for education.

V-9. NARROW FEDERAL VOCATIONAL EDUCATION AID

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	270	290	310	330	350	1,550
Outlays	25	220	290	310	330	1,175

Federal support for vocational education could be reduced by targeting support more narrowly toward students with special needs. Current federal aid provides about $740 million to localities and states to support vocational education, but only about 30 percent of the federal funds are focused on disadvantaged students, who include the handicapped and students with limited proficiency in English as well as the economically disadvantaged. Eliminating the untargeted portion would reduce outlays by $2.3 billion over the 1985-1989 period. Diverting half of the savings toward increased services for students with special needs would reduce the savings to $27 million in 1985 and $1.2 billion over the 1985-1989 period, as shown in the table.

This proposal would reduce overall public-sector spending for vocational education only slightly, since federal funds account for roughly 10 percent of the total. It would also reduce by very little total federal support for elementary and secondary education. At the same time, it would increase the services provided to some groups of students who are particularly likely to need employment-related training.

On the other hand, a reduction in vocational education support may be considered untimely, on grounds that economic conditions require new and increased training efforts. Indeed, ongoing technological advances--such as the advent of robots, word-processors, and computers in the workplace--may require substantially more, not less, spending for vocational education to make training relevant to a changing job market.

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V-10. REDUCE FEDERAL SUPPORT FOR NON-NATIONAL LIBRARIES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	90	100	100	110	110	510
Outlays	20	60	100	100	110	390

Federal support for libraries is currently provided through the Library Services Act of 1956 and Title II of the Higher Education Act of 1965 (with subsequent amendments). Elimination of these programs would reduce outlays by $20 million in 1985 and by $390 million over the 1985-1989 period. Because spending under new budget authority is spread over three years, outlay savings would be small in the initial years.

Since federal support represents less than 8 percent of all spending for library services, its withdrawal might have little adverse effect. Further, about 75 percent of federal support is provided under the Public Library Services program, the primary purpose of which is to expand services in underserved areas. Today, however, that purpose has been largely accomplished; an estimated 96 percent of the population has access to some form of public library services.

Opponents of such a withdrawal of federal aid point out that the monies help strengthen major research libraries and encourage interlibrary cooperation. Federal programs are credited with fostering the expansion of interlibrary lending, which facilitates research and scholarship throughout the nation. Elimination of all federal support for non-national libraries might threaten the continuation of these efforts. An alternative to total elimination of federal assistance would be to terminate the Public Library Services program while continuing programs for major research libraries and for interlibrary cooperation. In this case, outlay savings in 1985 would be about $17 million, accumulating to $300 million by 1989.

V-11. INCREASE STATES' COST-SHARING IN THE WIN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	110	120	130	130	140	630
Outlays	100	120	130	130	140	620

The state-run Work Incentive (WIN) program--with 1983 federal outlays of $289 million--provides job-search assistance, training, and related services to recipients of Aid to Families with Dependent Children who are able to work. In fact, employable AFDC recipients must register for the program or for certain alternatives. Currently, the WIN program's cost-sharing requirement for states is 10 percent. This could be increased to equal the state share of AFDC payments, which varies among states from 22 percent to 50 percent. The federal share of costs for WIN services would then drop from 90 percent to an average of about 54 percent--the average federal share of AFDC payments. Outlay savings would be $100 million in 1985 and $620 million over the 1985-1989 period.

Present service levels would likely be maintained, since states that did not provide the higher matching payments could face loss of federal cost-sharing for AFDC benefits under current law. (The above estimate assumes that total services financed by federal and state contributions would remain at 1984 levels.) In addition, the quality of services might be improved, since states would have a larger financial stake in the program. Increased cost-sharing would, however, increase the states' financial burden.

Another approach would be to reduce the federal share of WIN costs to an average 54 percent while reducing federal appropriations by a smaller amount--permitting an increased level of services at reduced federal costs. If this approach were taken, near-term federal savings would be lower than the estimates shown above. In later years, though, additional federal savings in the AFDC, Medicaid, and Food Stamp programs could follow from reduced benefits for however many WIN participants became employed. Though this approach would require more total federal/state spending for WIN than the first approach, preliminary estimates show that later federal savings in benefit payments could exceed the additional federal costs if the most cost-effective services were provided. This would involve a focus on intensive job-search assistance for participants who are ready, with training reserved for those lacking current employment skills.

V-12. REQUIRE COST-SHARING FOR VA HOSPITAL CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	90	220	275	330	375	1,290
Outlays	90	220	275	330	375	1,290

The Veterans Administration (VA) currently provides free hospital care to two main groups of veterans: (1) those with service-connected disabilities; and (2), as beds are available, those without such disabilities. Among those without service-connected injuries or illnesses--now 70 percent of all patients--are veterans who swear they cannot defray the costs of care elsewhere and other special groups of veterans such as those age 65 or older, who are eligible for care without regard to income or financial need. If copayments were required of all nonpoor veterans without service-connected disabilities, and if the copayments were set equivalent to those under Medicare for the first 90 days of inpatient care, resulting receipts could reduce five-year VA outlays by $1.3 billion (net of administrative costs).

Proponents of such a change hold that the VA's primary responsibility is to provide medical care to veterans with service-connected disabilities. Establishment of deductibles and coinsurance requirements for those without such disabilities would cause some reduction in the use of VA services--which is expected to rise significantly over the next five years owing to the increasing numbers of elderly veterans--by taking away part of the attraction of VA care over private care facilities. This, in turn, would help ensure that VA services continue to be adequate to meet the needs of service-disabled and poor veterans. It would also shift some of the rising costs of medical care to recipients, many of whom are accustomed to cost-sharing arrangements at non-VA facilities.

Opponents believe, however, that the country owes its elderly veterans free medical care, and that copayment requirements would unfairly burden some veterans or limit their access to necessary care. Although VA patients would pay only a small portion of the costs of their care, critics might also object to requiring copayment from some war veterans simply because they were not defined as poor.

V-13. CONVERT UNDERUSED VA HOSPITAL ACUTE-CARE BEDS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	45	45	165	165	170	590
Outlays	40	70	100	90	115	415

An ongoing shift in the patient population of Veterans Administration (VA) hospitals suggests that there may be an imbalance in the proportion of beds used for patients requiring short-term or acute care versus long-term care. The VA now operates 172 hospital centers and 101 nursing homes. Established when demand for VA hospital care was expected to be high, some VA hospitals have recently experienced very low occupancy rates. Meantime, VA hospitals are seeing rising demand for long-term-care beds, largely because the veteran population over age 65 is growing rapidly. This shift often results in long-term-care patients' occupying acute-care beds. If the VA converted its underused acute-care beds to nursing-home care, it could scale back plans for the costly construction of new nursing homes. This would reduce the staffing and equipment costs associated with operating acute-care beds. Cumulative five-year savings from converting roughly 3,000 of the VA's 80,000 hospital beds between 1985 and 1989 would be about $415 million.

Advocates of such conversions point not only to potential budgetary savings but also to the prospect of better suiting VA medical service to the patient population. On the other hand, because use of VA hospitals varies from place to place, few beds would be available for conversion in some locations, while many more--even entire hospitals--might be converted to long-term care in other areas. Opponents of such a plan view the potential reduction in hospital capacity in some areas as a serious threat to veterans who might prefer VA over private-sector hospital care. Cutbacks in coverage under the Medicare and Medicaid programs, they note, could motivate such a preference.

V-14. END FUNDING FOR LEGAL SERVICES AND JUVENILE PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
End Legal Services						
Budget Authority	300	310	330	350	370	1,660
Outlays	260	310	330	350	370	1,620
End Juvenile Justice and Delinquency Programs						
Budget Authority	75	80	85	90	90	420
Outlays	20	50	75	85	85	315
Total						
Budget Authority	375	390	415	440	460	2,080
Outlay	280	360	405	435	455	1,935

In 1984, the federal government will spend more than $270 million to help provide free legal assistance in civil matters to the poor and about $70 million to support research, education, training, and related efforts in the area of juvenile justice and delinquency. Terminating assistance for legal aid and juvenile justice in 1985 could reduce federal outlays by $1.9 billion over five years.

Though the Administration has repeatedly proposed abolishing both programs, the Congress has rejected such proposals. The programs' defenders claim that targeted federal assistance is the only way to ensure the availability of funds for legal services and juvenile programs. They maintain that recent increases in the number of poor and the continuing high rates of crime committed by the young make reliance on less secure funding sources undesirable.

Proponents of cancelling both programs argue that responsibility for legal assistance and delinquency prevention is a wholly nonfederal matter. Support from other federal grants, private sources, and donated services, they claim, could help to meet state and local priorities for legal aid. Continuing decreases in both the size of the youth population and in the overall crime rate, they also claim, justify diminished federal involvement. Critics also believe that the $0.7 billion committed since the inception of the juvenile delinquency program in 1975 has provided ample opportunity for demonstration of new approaches to delinquency problems.

V-15. REDUCE FUNDING FOR COMMUNITY AND ECONOMIC DEVELOPMENT

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	1,000	1,050	1,100	1,150	1,200	5,500
Outlays	50	450	900	1,040	1,110	3,550

Federal spending for community and economic development could be reduced and targeting toward hardest-pressed recipients maintained by disbanding the Economic Development Administration (EDA) and ending entitlement grants to well-off jurisdictions in the Community Development Block Grant (CDBG) program. The EDA provides financing primarily for public works projects, along with some planning and technical assistance to states and localities; its 1983 program funding totaled $299 million, including $100 million in emergency jobs funds. The CDBG program provides funding for a range of locally designed activities, most commonly public works projects, housing rehabilitation, and economic development. About two-thirds of program funds are disbursed on an entitlement basis to central cities, to cities over 50,000 in population, and to urban counties; the remainder are generally distributed by state governments among smaller communities. Funding for the CDBG program in 1983 totaled $4.5 billion, including $1.0 billion for emergency jobs creation. Federal spending could be reduced by $3.6 billion over the 1985-1989 period if the EDA were eliminated and if the entitlement component of CDBG were cut by 30 percent, with the remaining CDBG funds limited to localities with the most difficulties and the least resources.

The EDA has been criticized both for providing aid with little effect on economic activity and for setting such loose eligibility standards that most of the U.S. population lives in communities that qualify. Further, the entitlement component of the CDBG program provides aid regardless of local ability to finance activities, although jurisdictions with scarce resources receive relatively larger grants than other communities.

The EDA does, however, aid communities experiencing economic distress and in some areas provides infrastructure necessary for increased economic activity. Also, though some communities entitled to CDBG aid are relatively affluent, all must use funds to aid low-and moderate-income households, to eliminate slums and blight, or to meet emergency needs. Many such activities would be curtailed by either program cut.

V-16. MODIFY THE DAVIS-BACON ACT

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Index and Raise to $40,000 the Minimum Contract Threshold						
Budget Authority	65	70	70	75	80	360
Outlays	20	40	55	60	70	245
Allow an Unrestricted Use of Helpers						
Budget Authority	650	685	720	755	790	3,600
Outlays	195	415	550	625	685	2,470
Total Savings						
Budget Authority	685	720	760	800	835	3,800
Outlays	205	440	580	660	725	2,610

Since 1935, the Davis-Bacon Act has required that "prevailing wages" be paid on all federally funded or assisted construction projects of $2,000 or more. Current procedures for determining prevailing wages and the classifications of workers receiving them sometimes favor union wage scales. They also restrict use of lower-wage, less-skilled workers such as helpers, with the result that most workers on federal projects are paid journeymen's wages. The combined effect of these procedures is to raise federal construction costs by an estimated 2.0 percent. Davis-Bacon also raises wages in other ways--such as reduced competion--increasing federal costs by an additional 1.7 percent. (See CBO, Modifying the Davis-Bacon Act, July 1983.) Recently relaxed regulations will change how prevailing wages are set and allow greater--though still restricted--use of helpers. Both changes should reduce federal construction expenditures.

Federal outlays for construction could be further reduced if the threshold for projects covered by Davis-Bacon were raised to $40,000 and indexed to rise with building costs, and if use of helpers were unrestricted. The higher threshold would save $245 million over the 1985-1989 period, and unrestricted use of helpers would reduce outlays by $2.5 billion. Total five-year savings from combining both these options would be $2.6 billion--somewhat less than the sum of individual options because each would reduce the savings from the other.

Besides limiting Davis-Bacon coverage to larger projects, the raised threshold would reflect increases in construction costs since 1935; indexing it would hold its value constant in real terms. Unrestricted use of helpers would, besides reducing outlays for construction, expand employment of less-skilled workers on federal projects. At the same time, though, wages for workers on projects no longer covered would probably fall as additional contractors--previously discouraged from bidding on Davis-Bacon projects--competed for federal contracts. Moreover, as a result of expanded use of helpers, formal apprenticeship and training programs on federal projects might decline, reducing opportunities for low-skilled and minority workers to gain access to skilled crafts.

V-17. CHANGE OVERTIME PROVISIONS FOR FEDERAL CONTRACTS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	610	630	660	690	720	3,310
Outlays	70	310	530	620	670	2,200

Two laws governing some federal contracts now require overtime pay for work beyond eight hours a day, whereas the Fair Labor Standards Act mandates overtime pay only for workweeks that exceed 40 hours. As a result, government contractors may incur appreciably higher overtime costs than do employers adhering to the Fair Labor standard. The Walsh-Healey Public Contracts Act (covering equipment and supplies) and the Contract Work Hours and Safety Standards Act (for federally assisted construction) could be changed to stipulate overtime pay only for contract work beyond 40 hours a week. Although standing contracts would not be affected, this option could reduce the cost of new contracts--currently valued at more than $100 billion a year. Definitive data are not available, but if efficiency gains from this change reduced new contract costs by 0.5 percent (probably a conservative assumption), outlay savings would be about $70 million in 1985 and $2.2 billion over the 1985-1989 period.

In addition to their direct effect on overtime pay, such changes might realize cost savings if relaxed overtime requirements encouraged more numerous, and possibly more efficient, firms to bid for federal contracts. Some firms are now deterred from bidding for covered contracts because they would have to alter their established work practices.

On the other hand, establishments that have negotiated an eight-hour overtime pay requirement might object to eliminating the federal overtime pay provision, since they could be less successful in winning federal contracts without the law's protection. Further, a longer work day could result in unsafe or unhealthful practices in some worksites.

V-18. REDUCE FEDERAL MASS TRANSIT AID

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Reduce Federal Share of Capital Grants						
Budget Authority	1,140	1,180	1,250	1,310	1,370	6,250
Outlays	70	300	570	820	1,130	2,890
End Federal Operating Subsidies						
Budget Authority	870	870	920	980	1,040	4,680
Outlays	790	870	920	980	1,040	4,600
Total						
Budget Authority	2,010	2,050	2,170	2,290	2,410	10,930
Outlays	860	1,170	1,490	1,800	2,170	7,490

Over the last decade, the federal government has assumed a major role in financing local mass transit systems. In 1983, federal outlays for mass transit totaled $2.8 billion for capital development and $760 million for operations. Outlay savings totaling $7.5 billion over the 1985-1989 period could be achieved by reducing federal participation in mass transit. At present, the federal share of transit capital grants ranges between 75 and 85 percent; limiting the federal share to 50 percent could yield savings of $2.9 billion. Withdrawing federal operating aid, now supporting about 13 percent of operating costs nationwide, could save $4.6 billion.

The current high federal share of transit capital financing discourages local authorities from weighing the full costs and benefits of potential transit investments. As a result, they may build heavily capital-intensive systems, such as new subways, instead of pursuing other, more cost-effective options. Similarly, they may invest in new equipment when maintenance and repair of existing facilities would be a more economical alternative. Limiting the federal share to half of capital-project costs would encourage local authorities to apply more stringent economic criteria to potential transit projects. At the same time, however, since this would at least double the required nonfederal share, state and local economies would feel added pressure.

In general, advocates of federal support hold that mass transit systems foster local economic development and help relieve urban congestion. Proponents also maintain that transit systems improve the mobility of disadvantaged groups, such as the poor, the elderly, and the disabled. By increasing fiscal pressure on nonfederal governments, cutbacks in federal assistance could result in higher fares and/or reduced service on many systems. Without federal operating subsidies, some small cities that are not heavily dependent on public transit would probably end service entirely. Terminating operating subsidies could also aggravate existing problems of deferred transit maintenance, unless major maintenance projects are eligible for federal capital grants.

V-19. INCREASE GENERAL AVIATION USER FEES

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year
	1985	1986	1987	1988	1989	Addition
Addition to CBO Baseline	930	970	1,000	1,000	1,020	4,920

At present, the Airport and Airway Trust Fund--the source of most federal spending for aviation--is financed largely by an 8 percent tax on passenger tickets. Other taxes, including fuel taxes for small private planes, furnish additional amounts. General aviation users (firms and individuals who own and operate aircraft for business or personal use) now pay only about one-sixth of their share of federal aviation expenditures. Although they account for more than one-fourth of federal costs, or about $1.1 billion during 1984, they paid only about $160 million in user charges (fuel taxes). Commercial air passengers, in contrast, currently pay slightly more than their share of costs.

Full recovery of general aviation costs would raise an additional $4.9 billion in budget receipts over the 1985-1989 period, assuming no change in projected general aviation activity. These revenues could be generated in several ways, including raising fuel taxes from the current 12 to 14 cents per gallon to about $1.00, or imposing a sales tax on the purchase of new planes and equipment to raise comparable revenues.

A large fuel tax would have two clear disadvantages: it would penalize users who have made investments on the expectation that rates would remain low, and it could encourage tax evasion. The impact of higher fees for general aviation would depend on the type of tax imposed and the type of general aviation user. A fuel tax to recover all costs would increase operating costs by an average of about 14 percent, with smaller percentage increases for most business aircraft. Non-business flyers (accounting for the vast majority of planes, but only a small fraction of total hours flown) make relatively little use of the federal aviation system and could be severely affected if there were no provision that their fees be correspondingly lower. A sales tax on new purchases would provide this assurance.

V-20. REDUCE FEDERAL AIRPORT ASSISTANCE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Limit Assistance to Airports Serving National Needs						
Budget Authority	390	410	430	450	470	2,150
Outlays	80	260	350	410	440	1,540
End Assistance for Financially Self-Sufficient Airports						
Budget Authority	220	230	240	250	260	1,200
Outlays	40	150	200	230	250	870
Total Savings						
Budget Authority	610	640	670	700	730	3,350
Outlays	120	410	550	640	690	2,410

To foster aviation, the Federal Aviation Administration (FAA) manages the user-supported Airport and Airway Improvement Program. Through it, federal matching grants support 50 percent to 94 percent of the costs of constructing and rehabilitating the nation's airports. For 1984, the Congress established an $800 million obligation ceiling for capital improvements to airports, and an additional $3 billion has been authorized for spending over the next four years. More than 3,000 of the nation's roughly 15,000 airports now qualify for federal assistance.

Selective withdrawal of federal support could yield five-year savings of $1.5 billion while leaving the focus of the program--on airports of genuinely national significance--intact. Today, only 66 airports serve nine-tenths of all commercial passenger traffic. Though congestion at these airports is a mounting problem, according to the FAA only 155 of the nation's 2,379 general aviation facilities (those serving small planes used for business and personal purposes) are likely to contribute measurably to relieve major airport congestion by drawing off traffic. Reduced federal support could be effectively targeted toward the 221 major and designated reliever airports. A somewhat reconfigured airport system would likely result.

An additional criterion for selective withdrawal of another $900 million in federal aid could be airports' financial self-sufficiency. Many airports have demonstrated the ability to support themselves from various nonfederal revenue sources--notably, municipal bonds, repaid by user fee receipts. Federal aid could shift away from such facilities and focus on those most in need of help, resulting in improved program targeting.

Advocates of maintaining the status quo would point to potential disruptions for relativeiy small commercial air carriers, which tend to operate out of the noncentral airports that would lose federal support under the above criteria. Moreover, direct subsidies are likely to be less costly to the Treasury than those provided indirectly through the tax exemption for municipal bond interest. Other objections to reduction of federal support center on loss of convenience to travelers and added cost burdens on local airport authorities and general aviation flyers.

V-21. RAISE HIGHWAY TAXES TO MATCH HIGHWAY OUTLAYS

Addition to CBO Baseline	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Raise Highway Taxes	0	100	600	1,300	2,600	4,600
End Exemptions	720	750	780	820	860	3,930
Total	720	850	1,380	2,120	3,460	8,530

The federal government, in partnership with the states, finances construction and repair of highways and bridges. The federal share was $8.8 billion in 1983 and will approach $17 billion a year by 1989 if current policies are continued--primarily because of increased motor fuel taxes enacted in 1982. Though the tax change will raise highway revenues to more than $12 billion in 1986, the Congress also increased authorizations to $15.5 billion. As a result, an $850 million gap between revenues to and outlays from the Highway Trust Fund is projected for 1986, to reach $8.5 billion over the 1985-1989 period. For a few years, surplus cash in the trust fund will suffice to cover this deficit, but at some risk, as several billion dollars are needed in reserve to ensure against possible shortfalls arising from forecasting errors or unforeseen events such as another oil shortage.

A balance of receipts and outlays could be restored either by reducing spending or increasing receipts from highway users. Revenue increases could be generated by further raising--to 10.5 cents--the current 9 cent tax per gallon of motor fuel. Alternatively, a higher levy could be imposed on heavy trucks, as this class of users now pays only 70 percent of the costs it occasions. The cost of some goods would increase if the subsidy to heavy trucks were reduced by higher taxes.

Revenues could also be increased by eliminating certain current tax exemptions. These benefit state and local governments, bus and taxi operators, and producers of gasohol. Economic grounds fail to justify these tax subsidies. All vehicles, whether publicly or privately owned, cause wear and tear on the nation's roads. The subsidy to gasohol producers, justified as contributing to the nation's energy independence, is large--equivalent to 50 cents per gallon of alcohol fuel--and appears excessive in light of gasohol's modest contribution to U.S. energy independence. Though elimi-

nation of these tax exemptions would promote more efficient allocation of resources, it would also add to financial pressure on state and local governments.

Alternatively, substantial savings could be achieved by gradually limiting spending in the federal highway program to the original emphasis on intercity arteries. At present, locally oriented routes account for more than half of the $25 billion (in 1981 dollars) needed to complete the remaining 1,500 miles of the Interstate system. Focusing federal aid on Interstate routes of national significance would reduce outlays by $10 billion over the next five years alone--enough to close the gap between revenues and spending. Withdrawing federal support for such routes, however, would involve breaking longstanding commitments and would force either substantially greater state and local expenditure or the curtailment of some construction and repair work.

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V-22. END CREDIT SUBSIDIES TO THE BONNEVILLE POWER ADMINISTRATION

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	0	-5	-10	-10	-10	-35
Outlays	430	240	260	260	290	1,480

The Bonneville Power Administration (BPA) is a federally sponsored agency marketing power in the northwestern states. Under the law establishing the BPA, the financial relationship between the BPA and the federal government must be on "a sound business basis," meaning that the BPA be self-financing in the long term. Federal investment in the BPA's power-related facilities totaled more than $7 billion for plant in service at the end of 1982.

The federal government subsidizes the BPA and its customers in several ways. First, though the BPA is required to repay the investment within "a reasonable period," current Department of Energy policy does not require inclusion of the amortized principal in BPA payments to the Treasury. The rates the BPA charges its clients include provisions for repayments, but instead of repaying its investment, the BPA often uses its receipts to finance other operations and investments. The BPA's cumulative repayments are therefore about $800 million less than they would be if repayments were made on an amortization basis. Second, the BPA pays interest on the unpaid balance to the Treasury, but the interest rate used is low--3.2 percent on appropriated investments made in the 1980-1982 period. Moreover, the BPA has deferred more than $200 million of the interest it owes on federal investments.

Putting the BPA relationship with the federal government on the sound business basis mandated would reduce federal outlays by $1.5 billion in the 1985-1989 period. Doing so would require two fundamental changes: the federal government would have to charge the BPA the Treasury borrowing rate on the unpaid balance of its appropriated investment, and the BPA would have to start repaying its debts to the government--including deferred payments--on an amortization basis. These changes, however, could result in increases in electrical rates to households and industrial consumers--on average, about 11 percent--relative to the CBO baseline.

V-23. RAISE FEDERAL IRRIGATION WATER PRICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	20	40	60	90	120	330
Outlays	20	40	60	90	120	330

The Bureau of Reclamation administers development of arid and semi-arid lands in 17 western states. Of the 30.1 million acre-feet of water delivered to users by the bureau each year, about 93 percent is sold for irrigation. The government bases fees for irrigation water not on its cost but on the users' ability to pay, forgiving entirely the government's cost of capital to build storage reservoirs and diversion works. In 18 major projects, the bureau sells water at an average price of $9.34 per acre-foot, while the average cost for these deliveries is about $58.00 per acre-foot, an 84 percent federal subsidy.

Most federally subsidized water is delivered under long-term contracts that the federal government cannot change unilaterally. But bureau spending for four types of projects--rehabilitation, expansion, service contracts, and new systems--could be fully recovered as need for them arises. In 1985-1989, the total receipts from full-cost user fees from these four types of projects would be modest--about $60 million. Other savings could result from the reduced demand for new irrigation systems because of the price increases of irrigation water under full-cost recovery. Forgoing construction on half the planned new projects could save about $270 million over the five-year period. Long-term potential savings are substantially greater--perhaps as much as $1 billion a year by the year 2000.

Though following such a course could slow the growth of western irrigated agriculture, it could make water available for higher-valued uses such as municipal supply. Proponents of full-cost pricing also contend that current subsidies promote inefficiency, indirectly causing water scarcities. According to the General Accounting Office, the government's full costs of delivering water often exceed the added income that irrigation brings farmers. Opponents assert that western agriculture has developed because of subsidized water prices and that full pricing would require major adjustments. In California, for example, charging full prices for irrigation water would increase the production cost of rice or cotton by 14 percent. Thus, full-cost pricing for irrigation projects would lower farm incomes and raise farm prices.

V-24. INCREASE USER FEES FOR THE INLAND WATERWAYS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	570	580	600	630	660	3,040
Outlays	570	580	600	630	660	3,040

Inland waterways are the nation's system of canals, locks, and dams that serve barge transport. Inland waterway user charges, in the form of fuel taxes, were instituted in 1981 and are being phased in; they will rise from 4 cents per gallon at the outset to a maximum of 10 cents per gallon in 1986 and thereafter. But the current user fee receipts fall far short of financing federal expenditures for inland waterways. If current policies continue, the U.S. Army Corps of Engineers will spend some $3.4 billion to build, operate, and maintain inland waterway facilities during the 1985-1989 period. By comparison, the current fuel tax will generate only about $350 million in budget receipts--about 10 percent of the projected five-year federal outlays. Full recovery of currently projected federal expenditures for inland waterways would save about $3 billion through 1989.

The user fees could take the form of direct lockage charges or segment tolls that reflect the actual costs of building, maintaining, or operating a particular facility or segment. Because of the wide variation in costs among waterways, a nationwide fee, such as a fuel tax, would result in users of efficient waterways helping to pay for less efficient ones.

Proponents of increased waterway user fees point not only to potential budgetary savings but to the screening out of uneconomical projects. Users would support only those projects yielding benefits in excess of the increased fees they would have to pay. Any reduction in the demand for new waterways would reduce both federal spending and user fee revenues. The increased cost of shipping by barge could, however, divert some traffic to competing railroads and reduce the income of barge operators or farmers. When traffic is diverted, either remaining users would pay higher fees or the level of revenues would be reduced below full recovery. Consumers of some commodities shipped by barge could pay more for those goods. Under a compromise approach, waterway fees could be set at less than full cost recovery; this would accommodate the concerns of those who note that competing modes--freight rail and trucks--receive some federal subsidy. The result could be a more equitable competitive footing for all three modes.

V-25. LEVY USER FEES FOR PORTS AND HARBORS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	500	520	540	560	580	2,700
Outlays	500	520	540	560	580	2,700

The Corps of Engineers spends more than $500 million a year to maintain and improve ports and channels that accommodate oceangoing vessels and Great Lakes shipping. The largest share of the Corps' resources is devoted to maintenance dredging for deep-draft navigation; other activities include construction and maintenance of jetties and breakwaters, channel widening, and anchorage construction.

If funding increases at the rate of inflation, the Corps will spend about $2.7 billion for deep-draft navigation during the 1985-1989 period--$2.4 billion for operation and maintenance and $0.3 billion for construction. A full-cost recovery fee that would recoup the entire $2.7 billion (24 cents per ton of commodity carried, on average) would raise the cost of exported goods slightly--for example, less than 1 percent in the cost of coal delivered to Europe. However, a full cost recovery fee would increase current port costs for coal by about 10 percent. If fees were set to recoup only the cost of operation and maintenance, the federal saving would be about $480 million a year (21 cents per ton). At this level, user fees would increase current port costs by less than 1 percent for containerized cargo, 4 percent for grain, and 9 percent for coal. The total costs of exported goods would increase by smaller percentages.

Proponents of port user fees argue that commercial shippers are readily identifiable users who benefit directly from Corps activities. Because shippers would hardly support projects requiring fees higher than the expected savings in shipping costs, user fees would reduce the demand for new dredging or construction projects. Fees would also promote equity because users, not general taxpayers, would pay the cost of the services.

Opponents point out that, if fees were set to recover costs at each port, many small ports would be forced to forgo maintenance dredging or perhaps close entirely. Uniform national tonnage fees, which would not reflect the varied costs of different ports, would probably not result in port closings. But they would cause larger, more efficient ports with low per unit costs to subsidize small ports with higher costs.

V-26. CANCEL LOW-DENSITY AMTRAK SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	280	300	310	330	340	1,560
Outlays	270	300	310	320	340	1,540

Amtrak was established in 1970 to ensure continuing intercity rail passenger service as private freight railroads withdrew from providing such service. The Congress initially funded Amtrak with the intention that it be self-sufficient after one year. (See CBO, Federal Subsidies for Rail Passenger Service: An Assessment of Amtrak, July 1982.) Now, however, all capital costs and one-half of operating costs--$700 million in 1983--require federal subsidization. Rail passengers received 24.0 cents per passenger mile in net federal subsidies in 1983, while intercity buses received a 0.1 cent net federal subsidy, and commercial aviation and automobile travelers covered their estimated federal costs fully through user taxes.

One means of reducing Amtrak's subsidy would be to eliminate routes that have low ridership and dim future prospects. The federal subsidy could be reduced by $1.5 billion over the 1985-1989 period if the Amtrak system were limited to those routes with the strongest current ridership and the best prospects for improved use and good financial performance--primarily in the Northeast Corridor, routes along part of the West Coast, and certain routes around Chicago. Limiting Amtrak so drastically would maximize its financial outlook while shifting less than one-half of 1 percent of intercity passenger traffic to other modes.

On the other hand, opponents of major route cancellations stress that Amtrak provides a national rail network offering reliable transportation in areas where air service may be limited or where bus service is vulnerable to bad weather. In addition, Amtrak could play a role in moving people during transportation disruptions resulting from such events as acute oil shortages or labor strikes against other modes.

V-27. REDUCE FEDERAL SUPPORT FOR BIOMEDICAL RESEARCH

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Budget Authority	480	500	530	560	590	2,660
Outlays	260	490	520	550	580	2,400

The federal government spends about $5.5 billion per year to support biomedical research, about three quarters of it through the National Institutes of Health (NIH). If appropriations for NIH research were reduced by 10 percent, the 1985-1989 savings would total about $2.4 billion.

Advocates of such a cut believe that federal spending for biomedical research is excessive. They point to the rapid growth in federal spending in this area--about 225 percent in the overall NIH budget between 1970 and 1980, approximately one-third more than the increase in the gross national product. In some areas, funding rose even more rapidly--funding for cancer research rose by 450 percent during the 1970s. Such rapid increases, they argue, channel funds to projects that produce less benefit than could be obtained through other uses of the funds.

Opponents of a reduction argue that high inflation in the medical care sector during the 1970s limited real growth in funding for biomedical research, and that recently spending growth has slowed. NIH appropriations for 1984 are about 30 percent higher than 1980 levels and, opponents maintain, large cuts could have long-term adverse effects on the country's biomedical research efforts. They contend that researchers unable to obtain federal funding would leave the field because private nonprofit support would not increase enough to offset this reduction. For example, private support for biomedical research would have to increase more than twofold from about $350 million to about $700 million a year, to offset a 10 percent cut. Also, unstable support levels could make it difficult to finance long-term research projects.

V-28. ABOLISH THE SYNTHETIC FUELS CORPORATION

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	0	0	0	0	0	0
Outlays	0	5	5	5	5	20

NOTE: Savings totaling $5 to $10 billion would be achieved over the 1990-2005 period.

Responding to energy price shocks and supply disruptions in the 1970s, the Congress established the Synthetic Fuels Corporation (SFC) in 1980 to supplement private lending for the commercial production of synthetic fuels. Government support was deemed necessary to foster commercialization of synfuels, which are produced from relatively abundant domestic resources (such as coal). The SFC is capitalized at $14.9 billion and is authorized to provide loan and price guarantees, purchase agreements, and direct loans. By the end of 1983, one project had received SFC support ($120 million in price guarantees). While terminating the SFC would yield savings of only $20 million over the 1985-1989 period, an additional $5 to $10 billion would be saved over the following 15 years. Savings would depend on the level of the commitments the SFC had made before termination.

Since the financial support provided by the SFC is designed to offset differences between synfuels' costs and the market price of oil, future expenditures of the SFC depend on developments in oil prices. Present trends suggest that oil price increases, if any, will be moderate throughout this decade, and that price decontrol has established adequate incentives for exploration and production. These factors have defused the urgency of the SFC. In fact, should oil prices continue to fall, continuation of the program could lead to outlays far in excess of those described above. If petroleum prices rise, the SFC may not be needed to provide incentives.

Supporters of the SFC would argue that its original rationale--namely, to offset the risks inherent in reliance on petroleum--still holds. Though softened energy prices have made those risks less urgent, promotion of an assured alternative energy source may still be warranted.

V-29. REDUCE NASA'S AERONAUTICAL RESEARCH AND DEVELOPMENT

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	390	400	420	440	460	2,110
Outlays	260	370	400	430	440	1,900

The federal government--through the National Aeronautical and Space Administration (NASA)--devotes roughly $300 million a year to commercially oriented aeronautical research and development (R&D) programs; this is in addition to its substantial defense-related support for aeronautical R&D through the Department of Defense. Some NASA funds support long-term R&D in areas that may be underfunded by private firms (aircraft noise and safety, for example). Other programs support the development of more fuel-efficient and better-performing aircraft--goals for which private incentives may be adequate. Eliminating NASA's commercially oriented aeronautical R&D programs could generate savings of $1.9 billion over the 1985-1989 period.

Advocates of retaining NASA's support note that reductions in these programs could have a negative effect on the international competitiveness of the U.S. civilian aircraft industry. Critics of this area of federal aid hold that there are no grounds for favoring this industry over others also facing international competition but receiving little R&D support. Top priority, they would note, must be accorded to adequate funding for defense-related aeronautical R&D.

V-30. ELIMINATE COMMERCIALLY ORIENTED ENERGY DEVELOPMENT

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	600	830	860	900	930	4,120
Outlays	320	670	820	880	910	3,600

Over the past decade, the federal government has spent substantial sums to develop energy sources that could reduce U.S. dependence on foreign oil and restrain energy price increases. In the Administration's original budget request for 1984, energy development projects were budgeted at $960 million. More than 90 percent was for nuclear projects (including the Clinch River Breeder Reactor, budgeted at $240 million); the remainder was for solar energy projects, conservation, geothermal energy, and fossil fuels. Congressional action eliminated some funding for nuclear energy (including the Clinch River project) but added significantly to development funding for non-nuclear energy. In light of the current moderation of energy prices and the significant efforts that the government has already made to promote commercialization of alternative energy technologies, much of this activity could now be left to the private sector. Eliminating all commercial development programs could save $3.6 billion over the 1985-1989 period.

Such a step would ensure that market forces determine the rate at which different technologies are commercialized. They would also help select the most profitable areas of investment. These are worthwhile goals, since the government is unlikely to be more proficient at choosing specific technologies than the market itself. Reliance on market signals would improve the likelihood of investments being made in technologies with long-term promise.

At the same time, the original rationale for government funding of energy development projects cannot be dismissed. In the long run, alternatives must be found to compensate for the gradual depletion of attractively priced domestic oil and gas. Private-sector interest in alternative fuels has decreased in response to declining oil and gas prices, thereby strengthening the case for compensatory government support. Continued pursuit of new energy technologies may prove a worthwhile hedge against future price shocks and/or supply disruptions.

V-31. INCREASE CHARGES FOR THE SPACE SHUTTLE

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	70	180	340	450	560	1,600
Outlays	70	180	340	450	560	1,600

The National Aeronautics and Space Administration (NASA) expects to use the space shuttle for most future satellite launchings both for military purposes and for commercial use. Private firms currently pay NASA for launching their satellites, but these charges are below the full federal cost. The undercharges stem from several factors. First, launching charges have not been revised upward as cost estimates for the shuttle program have risen. Second, these cost estimates have been based on optimistic estimates of the number of future shuttle missions and satellite launches. Third, no attempt has been made to recover the research and development costs associated with the shuttle program, about $15.3 billion over the last 13 years. And fourth, NASA appears to want to maintain relatively low user charges to encourage maximum use of the space shuttle.

Rate increases for commercial satellite launchings by the space shuttle seem appropriate, since the clear beneficiary is private industry. Also, charges for military satellites were recently renegotiated at a higher level. Rate increases may be constrained, however, by the continued availability of capacity in nonshuttle rocket launchers, particularly in rockets developed and marketed by a consortium of European countries. Nevertheless, the estimated charge of $26 million for launching a typical communications satellite in 1986 could probably be increased by about 50 percent without risking losses in revenues. The charge would not include recovery of research and development expenses and, because of existing contracts, could not be applied to launches before 1986. Such an increase would generate total additional collections of about $1.6 billion over the 1985-1989 period. (Such collections would offset NASA outlays in the budget.) A greater increase might reduce use of the shuttle, thus forcing even higher charges on fewer users. If charges were applied to all types of missions, however, they could discourage the development of potential new industries, such as manufacturing in space.

V-32. ELIMINATE U.S. CONTRIBUTIONS TO THE U.N. DEVELOPMENT PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	170	180	190	190	200	930
Outlays	120	170	180	190	200	860

Through its contributions to the United Nations Development Program (UNDP), the United States supports U.N. efforts to give developing nations technical assistance and guidance on planning and coordinating development projects, with the goal of promoting political, social, and economic stability worldwide. The U.S. contribution--$160 million in 1984--makes up 20 percent of UNDP funding; most of the rest comes from Canada, Japan, and the European Community. Were U.S. contributions to UNDP halted, outlay savings of $860 million would accrue over the 1985-1989 period.

Spokesmen for the United States' withdrawal from UNDP see U.S. participation as duplicative of other efforts. Multilateral agencies, such as the World Bank and regional development banks, offer services of the same sort as UNDP's. Bilateral (direct) aid, such as that given through the U.S. Agency for International Development, does likewise, concentrating efforts on the poorest nations--a particular UNDP objective. Moreover, bilateral efforts give the United States greater control over distribution and use of U.S. assistance monies.

Advocates of U.S. participation in the UNDP argue the program provides valuable assistance to developing countries, particularly in formulating a coordinated development program to make effective use of all assistance from U.N. technical agencies and other multilateral and bilateral donors. Further, continued U.S. participation serves to convey U.S. concern for developing nations and enhances the United States' image worldwide and, specifically, its leverage on U.N. deliberations.

V-33. REDUCE ECONOMIC SUPPORT FUND FUNDING

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	310	320	340	350	370	1,690
Outlays	170	210	250	280	320	1,230

The Economic Support Fund (ESF), a descendant of the Marshall Plan of the 1940s, extends economic assistance to developing nations of political and strategic interest to the United States. The major share of ESF aid goes as cash grants or commodity-assistance support to recipient governments. The program's recent growth has been rapid, rising from $1.9 billion in budget authority in 1980 to $2.9 billion by 1984. Some 37 nations currently receive ESF funding, notably Egypt, Israel, Pakistan, El Salvador, and Sudan; and ESF disbursements constitute some 40 percent of U.S. nonmilitary economic aid to foreign nations. This upward trend could be reversed, however, and ESF funding cut by 10 percent. Resulting outlay savings would come to $1.2 billion over the 1985-1989 period.

Advocates of such a measure point to the ESF's failure to contribute to the economic growth and stability of recipient nations. ESF aid is provided unconditionally to support macroeconomic policies, rather than as project assistance aimed at building infrastructure or helping the poorest within those countries. Indeed, critics of the program assert that in some cases, by supporting inefficient economic policies, the ESF has effectively slowed development. Defenders of the program, however, cite its value as an instrument of foreign policy for fostering U.S. international interests. Any reduction of ESF funding, they note, could diminish U.S. influence abroad and create a risk to national security.

V-34. ESTABLISH USER FEES FOR CERTAIN COAST GUARD SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1985	1986	1987	1988	1989	
Budget Authority	1,050	1,100	1,150	1,150	1,200	5,650
Outlays	1,050	1,100	1,150	1,150	1,200	5,650

Four U.S. Coast Guard services, totaling more than $1 billion in annual federal spending, provide direct benefits to commercial mariners and recreational boaters. These programs--aids to navigation, search-and-rescue activities, marine safety, and marine environmental protection--could be funded through user fees.

Coast Guard services provide substantial, uncompensated benefits to civilian navigation, especially to the commercial shipping industry. For example, without navigational aids--such as buoys and other channel markings--commercial shipping in U.S. inland and coastal waters would be significantly more hazardous, difficult, and costly than it is now. The capital and operating costs of these aids could be recovered from the shipping industry, just as highway users pay for the costs of roads. The Coast Guard also engages in search-and-rescue operations for mariners who are lost or otherwise in trouble; about 72 percent of the Coast Guard's search-and-rescue activities assist recreational boaters. These search-and-rescue costs could be recovered through registration fees on recreational boats that use coastal and inland waterways, and through other fees on fishing and commercial vessels.

Over the 1985-1989 period, full recovery of associated federal costs would yield a total of $5.7 billion to offset Coast Guard outlays. On the other hand, such fees might be difficult to collect from recreational boats and would increase costs for the currently depressed fishing industry. If Coast Guard fees for fishing vessels were phased in over five years to avoid imposing too sudden a financial burden on this industry, the federal budget savings would be reduced by about $600 million for 1985-1989. Opponents of user financing for the Coast Guard's life-saving services see them as essential responsibilities that the federal government should take at any cost. In response, proponents would point to the nonfederal examples of firefighting and emergency services, two protective functions financed, through local taxes, by users.

V-35. REDUCE FEDERAL PAY ADJUSTMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Freeze Pay in 1985						
Budget Authority	1,670	1,890	2,000	2,110	2,230	9,900
Outlays	1,700	1,970	2,080	2,200	2,320	10,270
Delay Within-Grade Pay Raises						
Budget Authority	280	590	1,050	1,920	2,570	6,410
Outlays	280	590	1,050	1,920	2,570	6,410
Delay Annual Adjustments						
Budget Authority	460	770	840	870	900	3,840
Outlays	460	780	850	880	910	3,880

Current law provides for governmentwide pay adjustments every year based on procedures that compare federal salaries and wages with those paid for similar work in the private sector. Adjustments are made on a nationwide basis for 1.6 million federal white-collar workers at the same time each year--usually in October. For the 0.5 million federal blue-collar employees, adjustments occur on a local basis at different times throughout the year. In addition to annual governmentwide pay adjustments, most federal civilian employees (except managers and supervisors) receive periodic pay increases based essentially on length of service. The present waiting period for these so-called "within-grade" adjustments ranges from a minimum of six months to a maximum of three years. The adjustments, for all practical purposes, increase an individual's pay as a result of the time served in a particular position and do not imply changes in responsibility, although the Administration is seeking to place greater emphasis on job performance.

Forgoing all federal civilian pay adjustments (annual and within-grade) scheduled to occur in 1985 would achieve budgetary savings over the next five years of more than $10 billion. The Congress could also consider two changes that would reduce pay adjustments every year but with smaller budgetary effects. A permanent six-month extension of the waiting period for all within-grade adjustments and a three-month delay in the 1985-1989 effective dates for annual pay adjustments would generate five-year savings totaling $6.4 billion and $3.9 billion, respectively.

In assessing changes in federal pay procedures, the Congress will want to weigh potential budgetary advantages against the government's need to attract and retain a qualified work force. Proponents of limiting pay increases argue that even skipping an increase for a year would not be out of line with a number of recent union agreements or with the experience of the 18 state governments that have frozen or reduced their workers' pay-rate schedules. Proponents also note that the impacts of pay restraint on personnel recruitment and retention would be mitigated by slack job markets in most sectors of the economy.

Critics respond that certain job markets are tightening as unemployment rates decline and that pay austerity proposals have little in common with private compensation practices, leaving aside troubled firms. Although the Administration abandoned its plan to freeze the 1984 federal civilian pay adjustment, it delayed the increase for three months and capped it at 3.5 percent. This means that during the last three fiscal years federal pay rates will have increased about 12.8 percent--4.8 percent in 1982, 4.0 percent in 1983, and 3.5 percent in 1984. The three-year change in private-sector rates, as measured by the Employment Cost Index for the period ending October 1983, was 22.5 percent--about 1-3/4 times the growth in federal rates. Future actions that cause federal pay to lag behind the private sector's could lower the morale of federal employees, cause experienced employees with marketable skills to look for work outside the government, and make public jobs less attractive to prospective recruits.

V-36. MODIFY PERSONNEL AND PROPERTY MANAGEMENT PRACTICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Speed Up Regrading						
Budget Authority	0	60	200	340	530	1,130
Outlays	0	55	180	320	490	1,045
Contract Out						
Budget Authority	0	190	550	720	720	2,180
Outlays	0	50	240	390	420	1,100
Utilize Office Space						
Budget Authority	45	200	240	290	330	1,105
Outlays	20	80	100	130	160	490
Total						
Budget Authority	45	450	990	1,350	1,580	4,415
Outlay	20	185	520	840	1,070	2,635

Modifications in certain management policies governing the grading of federal jobs, the provision of services by support staff, and the use of office space could increase government efficiency and reduce costs. Savings through 1989 could total $2.6 billion relative to the CBO baseline.

Correct grading of federal jobs helps ensure that employees earn pay consistent with their duties and responsibilities. Under current law, when a job is downgraded the person in that job may keep the higher grade and pay for two years. Thereafter, the employee receives half the annual governmentwide pay adjustments until the salary of the top step of the correct grade catches up to his or her present salary. Five-year savings of $1.0 billion could result from a combination of accelerating correction of overgrading, dropping all overgraded employees to the step of the lower grade that is the same as their current step, and applying the half-pay adjustments immediately rather than waiting two years. Proponents argue that the government should not wait to achieve the efficiencies associated with correct grading, and that postponing salary adjustments eliminates budgetary incentives to regrade positions. Opponents maintain that current law cushions the effects of regrading on employees who have usually been misgraded through no fault of their own and that management needs the cushioning effect to make regrading acceptable and to maintain morale.

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Private contractors can often provide the government with support services at less cost than in-house federal workers can (see CBO report, Contracting Out for Federal Support Services: Potential Savings and Budgetary Impacts, October 1982). Administration policy requires reliance on the private sector but continues to exempt about three-fifths of support services, mostly those in the Department of Defense and the Veterans Administration, from contracting out, even if private contractors are cheaper. If contracting out were accelerated and exemptions relaxed, 180,000 jobs could be shifted to private firms, generating outlay savings accumulating to $1.1 billion through 1989 (assuming the program was phased in). Annual savings in later years could eventually total $1.4 billion. Advocates claim the government should not provide services that could be obtained from the private sector. Opponents believe current exemptions help to protect national security interests and ensure quality services for patients in veterans' hospitals.

Federal costs could be reduced by utilizing existing space more efficiently (see CBO, The Federal Buildings Program: Authorization and Budgetary Alternatives, June 1983). The General Services Administration (GSA) acquires and manages 147 million square feet of office space for federal agencies. A 15 percent reduction in space for executive branch employees, consistent with the Administration's goals, could reduce federal outlays by $490 million through 1989. This estimate assumes phased implementation of the new target over four years, with a minimum first-year reduction of 10 percent. Although it would improve space utilization, such across-the-board action could cramp some operations and decrease employee morale. Moreover, experience shows that lasting improvements are difficult to achieve, especially since overall use of federal office space already appears to compare favorably with private-sector practice.

CHAPTER VI. REVENUES

The Congress has passed two pieces of broad-based tax legislation in the last three years. The first of those tax bills, the Economic Recovery Tax Act of 1981 (ERTA), substantially reduced individual tax rates and liberalized the tax treatment of business investment. The second, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), reversed a portion of ERTA's tax reductions and increased revenues through a number of other provisions. TEFRA reflected Congressional concern over high and rapidly rising budget deficits, and met its 1983-1985 revenue increase goal almost precisely, but one of its major provisions, withholding on interest and dividends, was repealed by the subsequent Congress. The first budget resolution for fiscal year 1984 called for an additional $73 billion of revenues in 1984-1986 to narrow the budget gap further, but the Congress has not enacted the increase.

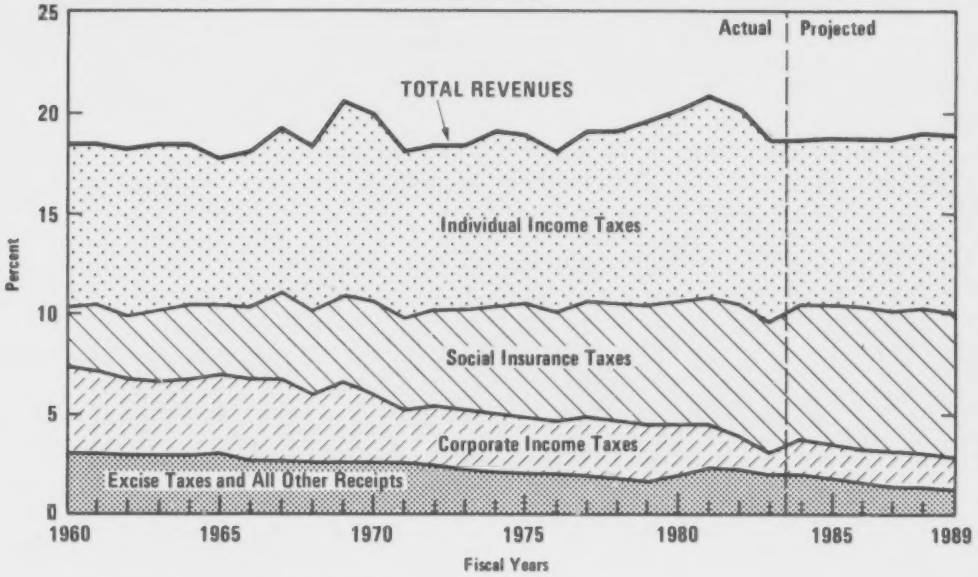
Despite the revenues raised by TEFRA, the federal budget deficit under current law is projected to be $326 billion in 1989, or 6.1 percent of the gross national product. This projection is made with the optimistic assumption that the economy will continue to recover and grow steadily through the rest of the decade. Such a substantial deficit would be unprecedented in a period of sustained economic growth, and its effects might well make sustained growth impossible. Preventing such a deficit is likely to require more than cuts in federal spending, since cuts of sufficient magnitude will be difficult to make. Thus, the Congress may need to raise additional revenues.

BUDGET HISTORY AND PROJECTIONS

Federal revenues are projected to rise slightly from 18.6 percent of GNP in 1984 to around 18.9 percent in 1989, which is about the average since 1960 (see Figure VI-1). Historically, revenues have fluctuated with the state of the economy, rising relative to GNP in periods of growth and falling in times of recession. Revenues have also been reduced during recessions by tax cuts designed to stimulate the economy, and (more rarely) increased by raising taxes in times of rapid growth and inflation or when deficits were large. Prominent among the tax cuts were those of the Kennedy-Johnson Administration in 1964 and of ERTA in 1981; prominent among the tax increases were the Vietnam War surcharge of 1969-1971 and TEFRA in 1982.

Figure VI-1.

Total Revenues as a Percent of GNP by Source, 1960-1989



SOURCE: Congressional Budget Office.

Since 1960, the contributions of different federal taxes to total revenues shifted markedly (see Table VI-1). The individual income tax has continued to yield between 40 percent and 50 percent of total revenues, but the share of the corporate income tax has dropped from 23 percent to 6 percent, while that of social insurance taxes has increased from 16 percent to 35 percent.

Recent History, 1980-1983

Federal revenues in 1983 were only $83.5 billion above the 1980 level of $517.1 billion, compared to an increase of more than $160 billion in the preceding three-year period. Relative to GNP, revenues fell from 20.1 percent in 1980 to 18.6 percent in 1983. The extremely slow growth of revenues resulted from the 1981-1982 recession, reduced inflation, and the enactment of ERTA. Individual income tax liabilities grew slowly over the three years, corporate income taxes fell precipitously, and social insurance taxes rose steadily (see Table VI-2).

TABLE VI-1. FEDERAL REVENUES BY SOURCE AS A PERCENT OF TOTAL REVENUES, 1960-1983 (By fiscal year)

Year	Individual Income Taxes	Corporation Income Taxes	Social Insurance Taxes and Contributions	Excise Taxes	Estate and Gift Taxes	All Other Receipts	Total Receipts
1960	44.0	23.2	15.9	12.6	1.7	2.5	100.0
1961	43.8	22.2	17.4	12.6	2.0	2.0	100.0
1962	45.7	20.6	17.1	12.6	2.0	2.0	100.0
1963	44.7	20.3	18.6	12.4	2.0	2.1	100.0
1964	43.2	20.9	19.5	12.2	2.1	2.1	100.0
1965	41.8	21.8	19.1	12.5	2.3	2.6	100.0
1966	42.4	23.0	19.5	10.0	2.3	2.8	100.0
1967	41.3	22.8	22.0	9.2	2.0	2.7	100.0
1968	44.9	18.7	22.2	9.2	2.0	3.0	100.0
1969	46.7	19.6	20.9	8.1	1.9	2.8	100.0
1970	46.9	17.0	23.0	8.1	1.9	3.0	100.0
1971	46.1	14.3	25.3	8.9	2.0	3.4	100.0
1972	45.7	15.5	25.4	7.5	2.6	3.3	100.0
1973	44.7	15.7	27.3	7.0	2.1	3.1	100.0
1974	45.2	14.7	28.5	6.4	1.9	3.3	100.0
1975	43.9	14.6	30.3	5.9	1.7	3.7	100.0
1976	44.2	13.9	30.5	5.7	1.7	4.1	100.0
TQ	47.8	10.4	31.0	5.5	1.8	3.5	100.0
1977	44.3	15.4	29.9	4.9	2.1	3.3	100.0
1978	45.3	15.0	30.3	4.6	1.3	3.5	100.0
1979	47.0	14.2	30.0	4.0	1.2	3.6	100.0
1980	47.2	12.5	30.5	4.7	1.2	3.9	100.0
1981	47.7	10.2	30.5	6.8	1.1	3.6	100.0
1982	48.2	8.0	32.6	5.9	1.3	4.0	100.0
1983	48.1	6.2	34.8	5.9	1.0	4.0	100.0

SOURCE: Federal Government Finances, 1984 Budget Data, various years, February 1983.

The Outlook

The revenue and spending targets in the fiscal year 1984 budget resolution, which would have helped to set the deficit into a modest decline over the 1985-1989 period, were not enacted. In addition, the growth of receipts in 1984 will be retarded by the final phasing in of ERTA's individual income tax rate reductions, estate tax reductions, and other provisions. The economic recovery will offset these cuts in revenues by adding to taxable incomes. Overall, receipts for 1984 are projected to grow at about the same rate as GNP, rising by $62 billion to $663 billion.

TABLE VI-2. FEDERAL REVENUES BY SOURCE, 1980-1989

Revenue Source By Type of Tax	Actual 1980	Actual 1983	Estimated 1984	Baseline Projection 1985	1986	1987	1988	1989
				In Billions of Dollars				
Individual Income	244.1	288.9	293.6	328.7	361.6	396.0	437.7	477.9
Corporate Income	64.6	37.0	62.3	64.8	71.1	81.3	84.9	85.1
Social Insurance	157.8	209.0	237.3	268.6	295.6	319.6	354.4	382.1
Excise	24.3	35.3	37.6	37.6	32.7	32.0	32.5	33.1
Estate and Gift	6.4	6.1	5.9	5.6	5.1	4.6	4.3	4.7
Other	19.9	24.3	26.2	27.6	28.6	29.9	31.2	32.8
Total	517.1	600.6	663.0	732.9	794.8	863.4	945.0	1,015.6
				As a Percent of Total Revenues				
Individual Income	47.2	48.1	44.3	44.8	45.5	45.9	46.3	47.1
Corporation Income	12.5	6.2	9.4	8.8	8.9	9.4	9.0	8.4
Social Insurance	30.5	34.8	35.8	36.7	37.2	37.0	37.5	37.6
Excise	4.7	5.9	5.7	5.1	4.1	3.7	3.4	3.3
Estate and Gift	1.2	1.0	0.9	0.8	0.6	0.5	0.5	0.5
Other	3.9	4.0	4.0	3.8	3.6	3.5	3.3	3.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
				As a Percent of GNP				
Individual Income	9.5	9.0	8.2	8.4	8.5	8.6	8.8	8.9
Corporate Income	2.5	1.2	1.8	1.7	1.7	1.8	1.7	1.6
Social Insurance	6.1	6.5	6.7	6.9	7.0	6.9	7.1	7.1
Excise	0.9	1.1	1.0	0.9	0.8	0.7	0.6	0.6
Estate and Gift	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Other	0.8	0.8	0.7	0.7	0.7	0.6	0.6	0.6
Total	20.1	18.6	18.6	18.7	18.7	18.7	19.0	18.9

SOURCE: Congressional Budget Office.

In later years, economic growth should continue to raise revenues--from $733 billion in 1985 to $1,016 billion in 1989. Relative to GNP, revenues are projected to rise from 18.7 percent in 1985 to 18.9 percent in 1989. Since budget outlays are projected to rise from 23.7 to 24.9 percent of GNP, however, this means that the deficit gap will widen.

REVENUE-RAISING OPTIONS

The simplest way of raising revenues would be to raise tax rates within the existing system. However, erosion in the income tax base (the components of income actually subject to tax) is significant, and rates are high; any further increase in rates may be undesirable. That is, higher rates could further distort decisions about working, saving, and investing. Alter-

natively, broadening the tax base by eliminating tax preferences could reduce tax distortions and simultaneously raise revenues.

Tax-base broadening could involve selective repeal or restriction of preferential provisions of the tax law. The aim would be to make the tax system more equitable and to reduce the influence of taxes on economic decisions. Any particular base-broadening measure should, of course, be judged on its own merits. Each special provision of the present tax code has been defended in terms of some social or economic purpose; the question is whether the defense is still valid and, if so, whether it could be better served in some other way--perhaps through a direct outlay or a smaller tax subsidy.

Base broadening could be expanded to include the repeal or restriction of most or all preferential tax provisions. This could raise significantly higher amounts of revenue and even allow a reduction in tax rates. The economic issues that would be raised by such large-scale base broadening are discussed below.

A third strategy would be to institute an entirely new tax or a set of taxes on specific activities. A relatively small-scale tax could be added to the existing tax system, one that would raise a limited amount of revenue. As examples, several energy taxes are reviewed in the specific deficit-reduction options that follow this overview (Option VI-25). On a larger scale, a national sales tax or a value-added tax could raise enough revenue to eliminate a large proportion of the deficit, while a personal expenditure tax could replace the individual income tax and add further revenues, much like the result of broadening the income tax base.

Increasing Tax Rates

An increase in the rates of existing taxes might be the quickest and simplest way to raise substantial amounts of additional federal revenue. To close the 1985 deficit gap by tax increases alone, however, would require an across-the-board increase in excess of 25 percent of all tax rates.

Increasing Individual Income Tax Rates. As the largest single federal tax, the individual income tax is the most obvious candidate for higher tax rates. Rates could be raised in any number of ways. For example, all tax rates could be increased by the same percentage through an across-the-board surtax on tax liability. Given the structure of the individual income tax, raising tax rates is quite simple mechanically, and additional revenues could be collected through withholding shortly after the higher rates were

legislated. A 5 percent surtax on income tax liabilities would raise about $16 billion in fiscal year 1985, increasing to about $24 billion in 1989.

Such a rate increase would, however, involve some significant policy risks and disadvantages. Increasing marginal income tax rates (that is, the tax that an individual must pay on an extra dollar of income) would clearly entail some economic cost, though precisely how much is uncertain and controversial. As Table VI-3 shows, marginal tax rates under the individual

TABLE VI-3. AVERAGE AND MARGINAL INDIVIDUAL INCOME TAX RATES AT MULTIPLES OF MEDIAN INCOME, SELECTED YEARS

Year	25 Percent of Median Income	50 Percent of Median Income	Median Income	Twice Median Income	Five Times Median Income	Ten Times Median Income
			Average Rates			
1965	0.0	2.8	7.4	12.2	20.5	36.5
1978	-7.3	3.4	11.6	17.3	30.9	41.0
1981	-8.4	5.7	13.3	18.5	31.7	40.6
1984	-5.4	5.9	11.9	16.0	26.1	32.2
			Marginal Rates			
1965	0.0	14.0	17.0	22.0	39.0	55.0
1978	10.0	16.0	22.0	36.0	55.0	66.0
1981	12.5	18.0	24.0	43.0	59.0	68.0
1984	12.5	14.0	22.0	33.0	45.0	50.0

SOURCE: Congressional Budget Office.

NOTE: Computed for families of four with typical standard or itemized deductions for the particular income level in the particular year; median income for tax-filing families: 1965, $7,500; 1978, $18,500; 1981, $23,700; 1984, $28,000. The 50 percent maximum rate on income from labor is assumed not to apply. The 1981 tax rates do not include the influence of ERTA. The negative average tax rates for the 25 percent of median income families reflect the refundable earned income tax credit.

income tax moved upward rapidly between 1965 and 1981, pushed along by inflation and bracket creep despite frequent statutory tax cuts. Those tax cuts increased personal exemptions and standard deductions (zero bracket amounts) among other changes, but for the most part left the basic rate structure unchanged. Since 1981, the three-year ERTA rate cuts have partially reversed this trend.

In addition to possibly increasing disincentives to productive activity such as working and saving, an increase in marginal tax rates at this time could eliminate a substantial portion of the reduction of marginal rates experienced by some taxpayers under ERTA. Inflation since 1981 has already partially offset the ERTA rate cuts by pushing taxpayers upward through the tax brackets. Indeed, by calendar year 1984, a median-income family's marginal tax rate will be only two percentage points, or about 10 percent, lower than in 1981, in spite of the three-year cuts under ERTA. Thus, a 10 percent surtax would eliminate the entire marginal rate reduction for such families. Because the tax rate at higher income levels was reduced from 70 percent to 50 percent, however, most taxpayers in the highest bracket would still have lower marginal tax rates than before ERTA, even with a surtax.

A final issue is the fairness of rate increases when much of the public believes that the income tax is already unfair. To the extent that some taxpayers use special provisions of the tax law to shelter their income from tax, they would not be burdened significantly if tax rates were increased. The burden of a rate increase would bear most heavily on those whose incomes are most fully subject to tax.

In sum, increases in the individual income tax rates could add substantial revenues quickly and relatively simply, but would entail economic costs and could be regarded as unfairly lenient toward those who are able to keep down their income tax burden through the use of preferential tax provisions and tax shelters.

Repealing Indexation. ERTA provides for individual income tax exemptions and rate brackets to be indexed, or adjusted for inflation, beginning in 1985. Some have proposed repealing this provision as a means of raising tax rates. Without indexing, nominal incomes grow but the tax brackets do not, and so more of each taxpayer's income is forced into higher brackets. Repeal of indexing means that average (and in many cases, marginal) tax rates would rise when nominal incomes grew. Based on CBO baseline economic assumptions, repeal would raise an estimated $6 billion in 1985, and $65 billion in 1989. However, revenue yields are highly sensitive to the rate of inflation. Thus, the yield from this proposal would be larger if

inflation were higher than assumed in the CBO baseline, or smaller if inflation were lower.

Since repeal would raise small amounts of additional revenues initially, but larger amounts in succeeding years as the effects of inflation cumulated, it would avoid shocking the economy in the near term, yet contribute significantly to deficit reduction in later years. In addition, because indexing has yet to take effect, its repeal would not take away a protection people have already come to rely on.

An unindexed tax system may have a beneficial anti-inflation effect: it tends to increase taxes and thus may help to cool off the economy when demand is growing too rapidly. Since raising taxes is a difficult political step, a system that raises taxes in response to inflation without requiring Congressional initiative has practical advantages. While periodic tax cuts would be necessary to keep tax increases from outrunning increases in real income, those tax cuts could be timed for years when the economy was relatively weak. Furthermore, without indexing the Congress has the periodic opportunity to direct tax cuts as it sees fit.

The case against repeal of indexing rests largely on the desirability of making the Congress be actively involved in any decision to increase the size of tax collections relative to incomes. With indexing, most of any expansion in tax yield would require an explicit vote to raise taxes, rather than riding through vote-free on the revenues from bracket creep under an unindexed system. The need for voting to increase taxes in real terms forces Members of Congress to balance the benefits of expanded programs against the costs of taxes to finance them.

Finally, indexation would help to maintain the integrity of the tax system by basing liabilities on a measure closer to real income, whereas an unindexed tax system leaves tax liabilities subject to a varying inflation rate that is difficult for taxpayers to predict. However, the simple bracket indexing in the present tax law does not solve the more complex problem of inflation-caused mismeasurement of income from capital: capital gains and interest income and expense.

Another issue in the debate over indexing is the effect repeal would have on the taxes paid by different income groups. The effect of a tax change on taxpayers at different income levels can be measured in several ways. The relative effects on different income classes will depend on the measure used. Under CBO baseline assumptions, repeal would increase the tax liabilities of low-income taxpayers more than others in percentage terms, but by very small numbers of dollars (see Table VI-4). Taxes of those at the highest income levels would increase least in percentage terms, but

most in dollars. If tax impacts are measured by percentage loss of after-tax income, the group losing the most from repeal of indexing is in the upper-

TABLE VI-4. THREE MEASURES OF THE TAX INCREASE FOR TYPICAL FOUR-PERSON FAMILIES IN 1985 DUE TO REPEAL OF INDEXATION[a]

1983 Income (Dollars)	1985 Income (Dollars)	1985 Tax With Index-ation (Dollars)	1985 Tax Without Index-ation (Dollars)	Tax In-crease[b] (Dollars)	In-crease (Per-cent)	Decrease in After-Tax Income (Per-cent)
5,000	5,509	0	0	0	0	0
10,000	11,019	375	413	38	10.1	0.4
15,000	16,528	1,090	1,121	31	2.8	0.2
20,000	22,038	1,763	1,807	44	2.5	0.2
30,000	33,056	3,433	3,528	95	2.8	0.3
50,000	55,094	8,223	8,459	236	2.9	0.5
100,000	110,188	24,909	25,351	442	1.8	0.5
250,000	275,469	86,340	87,156	816	0.9	0.4
500,000	550,938	192,395	193,211	816	0.4	0.2

SOURCE: Congressional Budget Office.

a. Assumes all income is from wages and salaries earned by one spouse; deductions are the greater of the zero bracket amount or 23 percent of income; and income increases equal the rate of inflation. Earned income tax credit is omitted. Inflation projections are from the CBO economic projections.

b. This column also measures the dollar decrease in after-tax income.

middle-income range. Because the tax increase would be caused by changes in the tax-rate-bracket boundaries, the tax increase would reach a plateau for all taxpayers in the highest tax rate bracket--which starts in 1984 at $162,400 of taxable income for couples, and $81,800 for single persons. As Table VI-4 shows, the maximum tax increase for a family of four in 1985

would be $816, thus diminishing the percentage loss in after-tax income for the very highest income groups.

Repeal of indexing is often termed unfair to families with incomes of $50,000 and under because it would raise their tax liabilities more in percentage terms than those of families with incomes of $100,000 and over. A surtax on tax liabilities, by contrast, would equalize the percentage increase in tax liabilities across income classes, thereby shifting more of the burden of a tax increase to high-income families than would repeal of indexing.

Several alternatives to outright repeal of indexation are available. The effective date of indexation could be postponed. A one-year postponement to 1986 would raise $6 billion in 1985, $10 billion in 1986, and slightly more each year thereafter. Alternatively, indexation could be provided for only part of inflation. One formulation would be to index only the inflation in excess of a given rate, perhaps 2 percent or 3 percent; taxpayers would be expected to absorb the effects of the first 2 percent or 3 percent of inflation, but would be protected thereafter. Restricting indexation to inflation over 2 percent would increase revenues by $3 billion in 1985, and by $67 billion over the 1985-1989 period. With a 3 percent threshold, the increase would be greater by about one-half. This approach has been widely discussed in conjunction with indexation of entitlement benefits (see Chapter IV).

Increasing Other Tax Rates. The effects of raising other federal tax rates would vary from tax to tax. The second largest federal tax is the payroll tax for Social Security. Its rates are chosen in conjunction with Social Security benefit levels and its revenues are earmarked for Social Security, so any change would raise issues regarding benefits--or the merit of reducing deficits by running intentional Social Security surpluses to reduce budget deficits.

Increasing corporate income tax rates might also be considered. Currently, the top-bracket corporate rate is 46 percent, applying to taxable income in excess of $100,000. Increasing that rate would have the disadvantage of increasing the distortions inherent in the corporate tax: its tendency to discourage investment in corporate businesses and to encourage finance through debt rather than equity. Furthermore, like a surtax on individual income taxes, a rate increase would have the most effect on those firms that are unable to take advantage of the various business deductions and exemptions. Alternatively, an option of increasing the lower corporate tax rate that applies to the first $100,000 of taxable income is discussed at the end of this chapter (Option VI-21). The lower bracket rate was intended to help small businesses, but some analysts contend that this method is

inefficient and poorly targeted because the lower rates are available to corporations of all sizes.

The options at the end of the chapter also include discussions of the pros and cons of increasing or extending temporary increases of the rates of several excise taxes, and the estate and gift tax (Options VI-28, VI-29). These taxes are smaller than the income tax, and so have a lower potential for raising large amounts of revenue.

Base Broadening

The tax code includes numerous deductions or exclusions from the individual income tax. These can reduce economic efficiency as well as revenues--unless they are targeted very carefully. Such concessions encourage taxpayers to engage in tax-preferred activities instead of others that may be of greater economic value. One example of this is the tax exemption for interest on pollution control bonds, which encourages firms to use expensive technological remedies for emissions when simpler and less expensive methods may be available (Option VI-15). Broadening the tax base by eliminating or cutting back such preferences could add to federal revenues and--to the extent that current incentives are less than optimal--direct resources toward more productive uses, thereby increasing economic efficiency.

Two general approaches to broadening the tax base are available. The first would repeal or restrict only a limited number of preferential tax provisions. TEFRA represents such an approach, with its limitations on the medical expense and casualty loss deductions and some corporate preferences. This approach does not change the basic character of the tax system, so the individual provisions can be considered on their own merits. Several such specific options, with their advantages and disadvantages are described at the end of this chapter.

The second general approach would broaden the tax base by eliminating all but a few special provisions. If base broadening were carried this far, a substantial net revenue yield would be possible, even with lower tax rates. The basic character of the income tax would change, so there is more to consider than the merits of the separate base-broadening steps that would make up the package.

Such a substantial broadening of the tax base could increase efficiency by encouraging resources to flow toward uses determined by the price system, rather than by the tax code. The lowering of statutory tax rates could reinforce this effect and could also increase the after-tax

reward to all productive activity and thereby boost supply incentives. Lower marginal tax rates would also make the distorting effects of income taxation less serious (for example, the overstatement of interest income, part of which is only a repayment of capital.)

A broader-based tax could also be more fair, since taxpayers with equal incomes would pay more nearly equal taxes than under the current system. The lower rates coupled with elimination of preferential tax provisions could make it less easy and less profitable to shelter income from tax, thus increasing public respect for and compliance with the income tax law.

These advantages of the broader-based income tax must be measured against the costs of such a quantum change in the tax structure. Achieving so broad a tax base would require drastic cutbacks in existing tax preferences--extending, perhaps, to the deductions for home mortgage interest and charitable contributions and to the exclusions from taxation of most Social Security benefits and employer pension contributions. While such tax preferences undeniably narrow the tax base, reducing revenues and distorting the allocation of resources, they also support activities that are widely considered to be socially valuable. Further, many private investments have been influenced by the existence of tax preferences, the repeal of which would not only increase tax liabilities but also lower the value of the assets affected. For example, repeal of the special capital gains treatment of cut timber would likely depress the price of timber land. (However, the value of assets not covered by such preferences would tend to rise.)

Another issue is tax complexity. While repealing some tax preferences would simplify the tax law, trying to measure and tax some types of income now excluded from the tax base (for example, employer-provided in-kind fringe benefits) could be difficult. Further, taxes on such benefits would have to be paid out of cash income, even though the corresponding benefits were not received in cash. If repeal of tax preferences were phased in, or tax preferences for existing investments "grandfathered" to protect their holders from loss, the transition procedures could be complex.

Changes would be even farther reaching if the corporate tax base were broadened in a manner analogous to the individual tax, notably by eliminating tax preferences for particular industries (such as oil and timber) and perhaps slowing down capital cost recovery. But businesses do not bear tax burdens themselves; ultimately they pass them on to shareholders, employees, customers, and/or suppliers. Corporations faced with increased tax burdens might adjust by cutting back on expenses, borrowing more, or reducing dividend payments. At the same time, treating corporations more neutrally in the tax law could lead to improvements in economic efficiency.

A broad-based individual income tax (with no itemized deductions; no increase in the exemption and the zero-bracket amount; full taxation of Social Security, other entitlement benefits, many employer-paid benefits, and long-term capital gains; and many other base-broadening steps) could raise revenues equal to those of the present income tax in calendar year 1985 with a simple flat rate tax schedule as low as 13 percent, or with a modified flat rate schedule comprising several brackets. Brackets could be arranged to ensure that there would be little change in the present distribution of tax liabilities by income group, although there would, of course, be significant redistributions within income groups. In future years, however, such a tax could raise more revenue than the current tax will. This could happen if the forms of tax-preferred income newly included in the broadened base, which have historically grown faster than income in general, continue to do so, or if they are converted into other forms of taxable income. Of course, such a tax could also tend to raise more revenues in future years than the current tax if the basic structure of the tax is not indexed for inflation.

In sum, a broad-based income tax could be more fair and also more conducive to economic efficiency than the current law. Against these advantages must be weighed the costs and difficulties of the transition, as well as the difficulties that may be encountered in altering the present structure of preferences.

New Taxes

Another way of addressing perceived shortcomings in the current tax system would be the establishment of an entirely new tax. If today's tax system cannot raise sufficient revenue without undue economic and administrative costs, then a new system may be needed.

One possible change would be a shift to taxes on consumption rather than income. Consumption is equal to income plus proceeds from borrowing less savings. Consumption-type taxes include the value-added tax (VAT), a general retail sales tax, and an expenditure tax. Another possibility would be energy taxes, which might be favored by those who want to encourage reductions in U.S. energy consumption.

Whatever the merits of new taxes, they also raise new issues of tax policy and administration. Legislating changes could take considerable time. Thus, introducing new taxes, like broadening the income tax base, could be less productive in the short term than simple tax-rate increases or selective base broadening.

Proportional Taxes on Consumption. Taxing consumption is favored by many who are concerned about capital formation. Unlike the income tax, a tax on consumption does not discriminate against saving. It permits savings to earn interest tax-free until they are spent; consequently, some believe that saving would be greater and current consumption smaller than under a tax on income. The degree to which consumption taxation would increase saving has long been subject to dispute, but it is not likely to be large. Personal saving appears to change little in response to changes in after-tax returns. Further, increasing personal saving by a given percentage has a much smaller impact on gross private saving because personal saving is less than one-fourth of gross private saving. The balance of private saving is contributed by corporations and unincorporated businesses. Longer-term consequences on the capital stock are likely to be somewhat greater, however, because the incremental increases in saving cumulate.

One way to tax consumption would be through a proportional tax levied on individual transactions, like the sales taxes of most states. Another formulation is the VAT used by many countries in Europe. A VAT has much the same effects as a national sales tax; but rather than being levied only at the retail level, it is levied on the value added at each stage of production. Experience with state sales taxes in the United States suggests that the sales tax might be easier to administer than a VAT. A national sales tax or VAT could in theory be applied to all consumption in the economy (about $2.8 trillion in calendar year 1985). If some forms of consumption such as housing, food, and medical care were exempted, the tax base would be reduced to about $1.2 trillion. This base implies that a 5 percent tax would yield $60 billion, before administrative costs.

Because a sales tax or a VAT would increase the tax burden of low-income households, some might argue for partially compensating relief, perhaps through exemptions of certain necessities from the tax. Alternatively, adjustments could be made to the income tax provisions affecting lower-income taxpayers to offset the sales tax burden.

Several other objections are raised against a sales tax or a VAT. It would most likely increase market prices when it was imposed, giving a one-time upward boost to inflation. As a new and additional tax, the sales tax or VAT would require new collection and administration procedures, and would impose a new burden on retailers. Also, because it would apply to nearly the same base as all state sales taxes, many states would see it as an intrusion on their revenue-raising capacity.

A Progressive Expenditure Tax. A personal expenditure tax is a consumption-type tax but, unlike a national sales tax or a VAT, it can be progressive. Individual taxpayers would compute their taxable expenditures

by adding to income any money borrowed and any withdrawals from savings, and subtracting any money saved (including repayment of previous borrowing). Each household could also claim some form of exemption, and the tax rates charged on taxable expenditures could be graduated so as to approximate the distributional impact of the current income tax.

A personal expenditure tax would have some desirable economic properties. Like a sales tax or a VAT, it would encourage saving more than an income tax, although the difference would probably be small. An expenditure tax would also be less vulnerable to distortion during periods of inflation than an income tax; because the cost of capital investments would be written off immediately, the mismeasurement of depreciation that can occur with an unindexed income tax base would not be a problem. A true expenditure tax that would allow deductions for all saving and place a tax on all borrowing could be a more efficient saving incentive, and less subject to manipulation, than the savings subsidies in the present income tax law.

Despite these advantages, the expenditure tax would also have some apparent disadvantages--chiefly in its departures from familiar attributes of the income tax. Because net saving would be tax deductible, the base of an expenditure tax would be narrower than that of an income tax, and therefore tax rates would have to be higher. The taxation of borrowed money (for example, at the time of purchase of an automobile) and the deductibility of saving would be unfamiliar to taxpayers. Significant increases in recordkeeping would be necessary for many taxpayers, though the complexities inherent in the current approach to taxing capital income would disappear.

Because borrowed money and withdrawals from saving would be taxable, the expenditure tax would bear relatively more heavily on households like the elderly who were dissaving to maintain their standard of living and on others in periods of unusually low income caused by illness, unemployment, or other uncontrollable factors. The transition to an expenditure tax could be unfair because taxpayers who had saved in taxable forms under the income tax, and were preparing to use the savings for consumption, would be taxed again as they consumed their savings unless they were allowed some form of deduction for their previously taxed saving during the transition to the expenditure tax. Meanwhile, retirees who had saved in tax-exempt forms (Individual Retirement Accounts, Keogh plans, interest earned on pension reserves, and as-yet-unrealized capital gains) should be taxed on their consumption. Distinguishing between already-taxed and untaxed saving for each individual taxpayer could create administrative problems. Cushioning taxpayers from hardships could make the transition from the income tax to an expenditure tax extend over a long time, thus

adding greatly to the complexity of the reform and reducing the potential near-term revenue gain from the new tax.

Since an expenditure tax would reduce the burden on capital income, some analysts argue for additional taxation of wealth, or taxation of gifts and bequests. Another issue would be the corporate tax, which has no theoretical role in an expenditure tax system but whose revenue yield would need to be continued or replaced from some other source.

Problems of international coordination would arise, because no other country has a personal expenditure tax. (India and Sri Lanka had one briefly, but both went back to the income tax.) Consequently, all U.S. bilateral tax treaties would have to be renegotiated.

Energy Taxes. Some analysts believe that the nation is still vulnerable to interruptions in its energy supply. They would favor new or increased taxes on energy to encourage conservation. In addition, a tax on imported oil might encourage domestic production. Several energy taxes are described at the end of this chapter, along with their relative advantages, costs, and effects on production and conservation (Option VI-25). While such taxes could raise several billions of dollars per year even at moderate rates, they would not likely play as large a role in an overall deficit reduction program as could new taxes on retail sales or personal consumption.

Specific Options

The following targeted revenue-raising options are grouped into income tax initiatives that affect primarily individuals (Options VI-1 to VI-11); income tax initiatives that affect primarily income received through business activities (Options VI-12 to VI-24); options related primarily to energy (Options VI-25 to VI-27); and others (Options VI-28 and VI-29). The revenue estimates presented here are for the policy steps taken individually; if more than one step was taken, interactions could follow that would make the combined revenue effect greater or less than the sum of the individual effects.

VI-1. LIMIT ITEMIZED INTEREST DEDUCTIONS TO $10,000 FOR JOINT RETURNS ($7,500 FOR OTHERS)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.3	2.0	2.2	2.4	2.6	9.5

Taxpayers who itemize can deduct all interest payments on home mortgages, auto loans, credit card balances, and other consumption borrowing. They also can deduct interest on borrowing that is invested--for example, in stocks--but this deduction is limited to $10,000 in excess of investment income. Just over one-third of all taxpayers itemize interest, claiming an average of $3,900 in 1982. Limiting all itemized interest deductions to $10,000 in excess of net investment income on joint returns ($7,500 in excess on other returns) would affect 1.5 percent of taxpayers and raise $9.5 billion in revenue from 1985 through 1989.

Interest is deductible to businesses and investors as a cost of earning taxable income. This rationale does not carry over to borrowing for homes, cars, and the like where no taxable income is forthcoming. Nonetheless, consumer interest deductions have been justified primarily as an incentive to homeownership. The above cap on interest deductions would leave a substantial incentive for home or other consumer borrowing. At a 13 percent interest rate, taxpayers filing joint returns could deduct all interest on at least $77,000 of borrowing; others could deduct all interest on at least $57,000 of borrowing. Decreased incentive for further consumer borrowing would free savings for business investment that increases productivity and economic growth. However, taxpayers with homes costing over $100,000 would probably suffer declines in real estate value.

Raising the limit to $15,000/$11,250 would reduce the number affected to 0.5 percent of taxpayers and raise $5.7 billion from 1985 through 1989. Alternatively, disallowing 5 percent of everyone's interest deductions would raise the same revenue as the $10,000/$7,500 limit, and it would spread the tax increase and any decline in house value more thinly over all itemizers. Limiting only nonmortgage interest deductions would avoid any impact on house values, but would favor expensive homes over cars, education, and other major purchases. Furthermore, homeowners might avoid the limit by financing other purchases with larger mortgages.

VI-2. TAX THE ACCRUED INTEREST ON LIFE INSURANCE RESERVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	2.1	5.7	6.2	6.8	7.5	28.4

Premiums paid for whole life insurance policies can be divided into the price of death protection and a separate saving component. The saving component builds up as a reserve or cash value that earns interest year by year. Taxes on this interest are deferred until the policy matures and the policyholder receives it. About 25 million taxpayers save through their insurance policies. If interest accruing as of 1985 were taxed, revenues of $28.4 billion would be raised over the 1985-1989 period.

The current-law deferral protects savers from having to pay taxes on income before it is received. Many view this as a matter of fairness; some would have difficulty in making the extra tax payment before receiving the investment income. The deferral also stimulates saving, particularly through life insurance policies.

Repeal of the deferral would tax saving through life insurance similarly to saving through banks, mutual funds, and other channels. Similar tax treatment avoids distortion in the allocation of savings among investments and thereby increases economic efficiency and growth. Furthermore, the decision to save through an insurance policy instead of a bank, mutual fund, or the like, is voluntary and therefore can be avoided if other income is likely to be inadequate to meet accrued tax liabilities.

The yearly revenue gains shown above represent taxes on interest accruing that year. Interest accumulated before the tax change would continue untaxed until received by the policyholder.

VI-3. REPEAL NET INTEREST EXCLUSION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	1.0	2.9	3.1	3.4	3.6	14.0

ERTA created an exclusion from tax of 15 percent of the first $3,000 of net interest income on individual returns ($6,000 on joint returns), effective January 1, 1985. Net interest income is defined as the difference between total taxable interest income and total itemized interest payments (exclusive of mortgage and business interest deductions). Repealing this exclusion would raise revenues by $14 billion from 1985 through 1989.

The provision was enacted to encourage saving, and thereby investment and economic growth. Proponents point out that, compared with some faster-growing nations, the United States has higher taxes on saving and a lower saving rate. They also note that taxation of all of interest income is excessive in periods of high inflation, because part of interest is compensation for erosion of principal rather than real income. The exclusion's $3,000/$6,000 limit curtails the revenue loss from the small proportion of large savers while providing the full incentive to the majority of taxpayers.

Questions have been raised about the appropriateness and effectiveness of the exclusion. The recent decline in inflation has reduced its appropriateness as an inflation adjustment. Its effectiveness is questioned by many studies that find saving responds little to changes in the after-tax interest rate. Also, the $3,000/$6,000 limit on the exclusion eliminates the incentive for many higher income taxpayers who could be most responsive to the incentive. If the exclusion fails to stimulate more new saving than it costs in lost revenue, the government's added deficit financing would actually reduce the amount of saving available for private investment.

A tax incentive for investment could be retained while raising revenue by combining the repeal of this interest income exclusion with a limit on the deduction of consumer interest payments (see Option VI-1). These would reduce government and consumer borrowing, thereby leaving more of the existing savings for business investment.

VI-4. TAX FRINGE BENEFITS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.5	0.7	0.8	0.9	1.0	3.9

Until December 31, 1983, the Internal Revenue Service was explicitly prohibited by law from issuing regulations necessary to tax many forms of employer-paid fringe benefits. (This prohibition did not affect the largest forms of non-cash compensation, which are tax exempt by statute; these include employer-paid premiums for life and health insurance (see Option III-17) and contributions to pension plans.) The prohibition removed from the tax base forms of compensation such as the private use of a company car, discounts on employers' products, reduced-price meals, subsidized day care, reimbursement for recreational expenditures while on business travel, tickets to sporting or cultural events, and club dues. Taxing only the personal use of company cars and employee discounts on airline fares would raise $3.9 billion of additional revenue over 1985-1989.

At present, a taxpayer with no fringe benefits pays the same tax as another with an equal salary and generous fringe benefits. Employees have a strong incentive to bargain for more of their compensation in the form of untaxed fringe benefits. This shrinks the overall tax base, increases the tax rates necessary for all taxpayers, and--in a continuing cycle--further increases the incentive to bargain for untaxed fringe benefits. The tax exemption further misallocates resources by inducing employees to bargain for fringe benefits they might not buy themselves. Thus, it encourages an employee in the 30 percent tax bracket to seek fringe benefits costing the employer $1 that the employee might not buy for more than 70 cents.

Some large items could be taxed cost-effectively. But valuing some fringe benefits for tax purposes could be complex; an example would be a reduced-price airline trip where the cost to the carrier of servicing one extra passenger is essentially zero. Further, taxing small fringe benefits, such as some employee discounts, would involve collection costs greater than the revenue to be collected. Of those fringe benefits subjected to tax, many would be converted to cash income by mutual agreement of employers and employees; this would add to tax revenues in the same way as the direct taxation of fringe benefits.

VI-5. REPEAL CHARITABLE DEDUCTION FOR NONITEMIZERS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.2	1.7	2.8	0	0	4.7

Taxpayers who take the standard deduction can claim a special itemized deduction for contributions to charitable organizations (as defined for the usual itemized deduction). This special deduction, enacted in 1981 as part of ERTA, is phased in over the 1982-1986 period. For 1983 the deduction is limited to 25 percent of no more than $100 of contributions, but by 1986 both the percentage and the dollar limits are eliminated. The provision is due to expire at the end of 1986. Eliminating this provision would raise $4.7 billion over the 1985-1989 period.

This provision was intended to encourage those who do not itemize to increase their charitable giving. Because many nonprofit organizations provide services that might otherwise be left to government, increasing the funds of these organizations was considered desirable.

The provision may be inefficient, however, because the revenue loss may be larger than the extra charitable contributions it generates since many deductions probably represent gifts that taxpayers would have made anyway. (Although economists are not agreed on this, the weight of the evidence seems to indicate that new contributions would be less than the tax loss from this provision.) In addition, because nonitemizers tend to be in relatively low income classes, the increases in their giving are likely to be quite limited. One final concern is that this special deduction may set a precedent for making more deductions available in addition to the standard deduction, thereby complicating the tax law and forms and further narrowing the tax base.

VI-6. INCREASE TAXATION OF ENTITLEMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Social Security	2.2	6.6	6.7	6.7	6.7	28.9
Railroad Retirement	*	0.1	0.1	0.1	0.1	0.4
Unemployment Compensation	*	1.4	1.4	1.3	1.2	5.2
Workers' Compensation	1.6	2.4	2.7	2.9	3.2	12.9

* Less than $50 million.

Under current law, certain entitlement benefits are included in adjusted gross income for tax purposes while others are exempt from the income tax. Taxing all benefits would reduce existing differences among different entitlement sources and between entitlement sources and other forms of income. As a rough way of achieving equivalent tax treatment with other retirement benefits, taxing half of all Social Security benefits and half the portion of Railroad Retirement benefits resembling Social Security would raise revenues by $2.2 billion in 1985 and by $29.3 billion through 1989. Taxing unemployment compensation fully (taxation of benefits now phases in as income rises) and workers' compensation benefits exclusive of medical costs would increase revenue by $1.6 billion in 1985 and by $18.1 billion through 1989. Revenue gains from taxing benefits from means-tested programs such as Aid to Families with Dependent Children (AFDC) would be small, since few people who qualify for means-tested programs would have enough income to incur any federal income tax liability.

Historically, most entitlement benefits were exempted from income taxation on the theory that they were forms of assistance to typically poor recipients. Moreover, because the transfer payments made to beneficiaries were usually small, the revenue loss from the tax exemptions was negligible. In recent years, however, such income transfers have reached more well-to-do households and gradually have accounted for much larger fractions of family income. In recognition of these changed circumstances, legislation in 1978, 1982, and 1983 has taxed portions of Unemployment Compensation, Social Security, and Railroad Retirement benefits.

Tax Half of All Social Security Benefits and Tier I Railroad Retirement Benefits. On the theory that income taxes are not paid on the employers' share of contributions to Social Security, the Congress included a provision in the Social Security Amendments of 1983 requiring that half of Social Security benefits for married individuals with incomes above $32,000 (for singles--$25,000) be treated as taxable income. The revenues from the provision are to be channeled into the Social Security trust funds. Railroad Retirement benefits, which are structured to parallel the Social Security (Tier I) and private pension (Tier II) components available to private-sector employees, also had their tax treatment adjusted in 1983 in line with treatment of their private-sector counterparts.

Taxing 50 percent of Social Security and Tier I benefits for all beneficiaries would serve a number of useful goals. First, it would bring the tax treatment of these entitlements further in line with other pension income, which is fully taxable to retirees after they have recovered their own contributions, if any. Second, it would reduce the rate of return of benefits over contributions for current and near-term retirees. Since these beneficiaries enjoy higher returns than is likely for today's workers, taxation of their benefits could be argued to be a move toward a more equitable balance between generations. Moreover, it would reduce the incentive to retire early; any increased labor force participation could further bolster the trust funds and lower current workers' payroll taxes. Taxing benefits for all could also eliminate any work or saving disincentives now facing beneficiaries near the threshold amounts of $32,000 or $25,000. On the other hand, to the extent that existing benefit levels have been set based on their tax-free treatment, taxing benefits might require raising benefit levels, thereby reducing potential budgetary savings. In addition, since payroll tax revenues will be adequate to cover benefits for the next few decades, there is no special reason to lower the real income of substantial numbers of elderly people.

Tax All Unemployment Insurance Benefits. Tax legislation in 1982 subjected more of unemployment compensation to tax by lowering the threshold income above which the benefits are taxed to $18,000 for couples and $12,000 for single tax filers, using a graduated formula.

Taxation of all unemployment benefits could be recommended on several grounds. Equitable tax treatment requires that the tax code not distinguish between different sources of income in determining tax liability; tax liabilities now differ, depending on the proportion of income coming from unemployment benefits, for taxpayers with incomes under the threshold amounts. In addition, the tax exemption of some unemployment compensation may discourage a return to work.

Critics of this option, though, would argue that those least able to afford a tax increase would be asked to bear it, and that the taxation of all benefits could have minimal effect on work incentives given the continuing high rate of unemployment.

Tax Workers' Compensation Benefits. Most workers suffering on-the-job injuries are insured by workers' compensation, which covers medical expenses and some portion of income loss. By far the costliest part of the program is the latter, accounting for about 75 percent of all payments. Taxing compensation benefits would remedy certain inequities by treating benefits like most other forms of income. Because in some cases the value of the tax-free benefits may exceed the lost wages net of tax, beneficiaries sometimes may have little incentive to return to work. It also is arguably unfair when one person receives tax-free workers' compensation while another earns equal amounts in wages but must pay tax.

Opponents of taxation would argue that benefit levels differ significantly from state to state, and hardships might result if low-benefit states did not increase their benefits to take account of the tax on them. Also, because court-awarded damages for income loss resulting from non-workplace injuries are not subject to tax, it would be unfair to subject similar payments to tax in the case of workplace injuries.

VI-7. ELIMINATE EXTRA TAX EXEMPTION FOR THE ELDERLY

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.9	2.6	2.7	2.9	3.0	12.1

Any taxpayer 65 or older is permitted to claim an extra $1,000 exemption. The most widely perceived reasons for this feature of the tax law are the lower income and extra costs of living (especially medical costs) of the elderly. Repeal of the extra exemption would increase revenues by $0.9 billion in 1985 and by $12.1 billion through 1989.

The extra exemption is criticized on several grounds. First, if the intent of the tax code is to aid those most in need, the outcomes produced by the additional exemption are perverse. The elderly whose income is so low that they do not file returns do not benefit from the extra exemption; in 1981, only 13.1 million extra exemptions were claimed by 26.3 million elderly Americans. By contrast, more than one-third of all 1981 tax returns with adjusted gross income of at least $1 million claimed an extra exemption for age. Second, the elderly who are in fact faced with extraordinary medical expenses can deduct them, so the extra exemption is not needed for that purpose.

Third, the extra exemption was adopted when Social Security benefits were low and the elderly had a much higher poverty incidence than the population in general (35.2 percent versus 22.4 percent in 1959). In 1982, largely because of Social Security, only 14.6 percent of the aged were in poverty (compared with 15.0 percent for all persons).

Proponents of retaining the exemption contend that it should be evaluated in the context of the overall transfer-payment system's goals, which include providing benefits to the elderly without regard to income criteria.

VI-8. ELIMINATE INCOME AVERAGING

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	1.3	5.5	5.9	6.4	6.9	26.0

The tax code allows income averaging by taxpayers experiencing large increases of income in a particular year. Without averaging, a taxpayer with an uneven income flow would, under progressive income tax rates, pay more taxes than one with the same total, but more constant, income over the same period of years.

The averaging provision was designed to allow more equitable treatment of taxpayers--inventors, for example--who receive relatively large payoffs in a short period for efforts expended over several years. Because of the rapid inflation during the 1970s, however, many taxpayers have become unintended beneficiaries--for example, those with rapidly growing incomes, such as recent graduates. In 1981, 6.9 percent of tax filers used income averaging--a nearly 19-fold increase since 1964. The best data show that averagers have incomes characterized by simple growth rather than variability and that their incomes are predominantly wages and salaries rather than lump-sum or transitory amounts. These characteristics are not consistent with the original intent of the provision. Elimination of income averaging would increase federal revenues by $1.3 billion in 1985 and by $26.0 billion over 1985-1989. Of course, repealing income averaging would also eliminate the benefit for all taxpayers whose incomes are concentrated into particular years, even those originally intended to be helped.

As an alternative to elimination, if averaging provisions were tightened to require a 40 percent increase over the average base-period income, rather than the current 20 percent, the number of averagers qualifying simply from income growth would decrease, and those eligible for averaging would more closely fit the original intent of the law. The revenue gain from this tightening of the code would be about $6.5 billion, compared to about $26.0 billion from eliminating averaging entirely.

VI-9. ELIMINATE DEDUCTIBILITY OF STATE AND LOCAL SALES TAXES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.8	5.6	6.3	7.2	8.1	28.0

Under current law, taxpayers may claim state and local sales taxes as an itemized deduction. Eliminating the sales tax deduction would increase federal income tax revenues by $0.8 billion in 1985 and by $28.0 billion through 1989.

Historically, the deduction for sales taxes was allowed to avoid taxing individuals again on previously taxed income. The appropriateness of continuing the deduction is being questioned currently, however, for two main reasons. First, while the tax code generally allows deductions for relatively large and unpredictable expenses that affect a taxpayer's economic circumstances, uniform expenses affecting nearly all taxpayers have traditionally been subsumed in the zero bracket amount and in the exemptions of the tax structure. The sales tax deduction, by virtue of the way it is computed (from standardized tax tables with amounts varying only by state, family size, and income) and its scope of coverage (claimed by nearly all itemizers) fails to meet these general criteria. Second, at a time when many believe that the nation would be better served by greater national saving, the sales tax deduction may promote exactly the opposite by reducing the cost of consumption.

Advocates of the sales tax deduction argue that the federal government should not influence the states' choice of taxes through selective deductibility. Eliminating this deduction would be more burdensome for states relying heavily on sales taxes and could cause some states to shift their tax collections from sales taxes to other taxes to preserve deductibility for their residents. Others contend that, because it is popularly held to be a fair tax, use of the sales tax should not be discouraged.

VI-10. IMPROVE TAXPAYER COMPLIANCE

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Increase Audit Coverage						
Increased Collections	0.9	1.9	3.3	5.1	7.2	18.4
Administrative Outlay Cost	-0.1	-0.2	-0.3	-0.4	-0.5	-1.5
Net Addition	0.8	1.7	3.0	4.7	6.7	16.9
Extend Withholding						
Interest and Dividends	1.0	2.1	1.7	1.8	1.9	8.6
Royalties	0.4	0.5	0.7	1.0	1.3	3.9
Contractors	0.7	1.1	1.3	1.4	1.5	6.0
Total Addition	2.9	5.4	6.7	8.9	11.4	35.3

Substantial evidence shows that compliance with the tax laws has been declining in recent years. The Internal Revenue Service estimates that about $90 billion in taxes went unpaid in 1981, an increase of nearly 200 percent since 1973 (58 percent after adjusting for inflation). Although illegal activities such as prostitution or drug trafficking are responsible for part of the "tax gap," it is estimated that 90 percent of the revenue shortfall results from underreporting or nonreporting of income from legal activities. Income underreporting is estimated to account for about 60 percent--about $52 billion in 1981. Overstated expenses, deductions, and credits account for $13 billion; nonfilers for $3 billion; and underpayments for about $7 billion. Corporations were responsible for $6 billion (6.9 percent) of the tax gap in 1981. While additional complex rules and regulations would be undesirable, tax evasion imposes an unfair burden on taxpayers who honestly comply. Improving taxpayer compliance would increase both revenues and fairness.

In 1982, the Congress adopted several compliance provisions in TEFRA that were projected to raise $51 billion over the 1984-1988 period. Other areas offer additional potential for improved compliance. The provisions outlined below could reduce the deficit $2.9 billion in 1985 and $35.3 billion over the 1985-1989 period.

Increase Audit Coverage. The number of examiners and data processing capacity at the IRS have not kept pace with either the workload or the increasing complexity of the tax code. Audit coverage has fallen from 2.6 percent of all returns in 1976 to an estimated 1.3 percent in 1984. Adding new IRS staff could have an immediate and large payoff in revenues--estimated by the IRS at about $9 or $10 for each additional dollar spent. Increasing the percentage of returns examined to 1.5 percent in 1985, rising to 1.9 percent in 1989, would raise about $0.9 billion in 1985 and $18.4 billion over the 1985-1989 period. The additional revenues would be partly offset by $1.5 billion in 1985-1989 outlays for additional staffing and data processing resources. This increased audit coverage, however, would impose additional compliance burdens on honest taxpayers.

Extend Coverage of Withholding. Increasing the coverage of withholding and/or raising withholding rates (where they have proved to be too low) could improve taxpayer compliance. In TEFRA, the Congress adopted withholding on interest and dividends and optional withholding on pensions, annuities, and lump-sum distributions. The provision for withholding on interest and dividends was subsequently repealed, however, and replaced by a less comprehensive system of withholding for taxpayers who fail to provide identification numbers or fail to report interest and/or dividend income. In the future, the Congress might want to reconsider regular withholding on interest and dividends. Such a measure would raise $1.0 billion in 1985 and $8.6 billion over the 1985-1989 period. Another option would be mandatory withholding on pensions and other retirement income.

Businesses could also be required to withhold taxes on royalty payments for items such as patents, copyrights, and oil and gas rights. Current law provides for information reporting on all royalty payments in excess of $600 on an annual basis; firms could be required to withhold taxes at a rate of 10 percent on all such payments. This proposal would raise $0.4 billion in 1985 and $3.9 billion in 1985-1989. Current law also requires information returns to be filed by employers of independent contractors on aggregate annual payments in excess of $600. Withholding could be applied to these payments at a rate of 10 percent, and contractors provided a W-2 form. This proposal would raise $0.7 billion in 1985 and $6.0 billion in 1985-1989. Any expanded coverage of withholding, however, may impose significant additional administrative costs on businesses.

VI-11. SPEED SETTLEMENT OF TAX COURT CASES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	*	0.1	0.1	0.1	0.1	0.4

* Less than $50 million.

The increasing backlog of cases docketed with the U.S. Tax Court impedes the settlement and collection of deficient taxes owed to the federal government. The 1983 year-end backlog of some 58,300 cases at the Tax Court about quadruples the 1973 level, while the number of Tax Court judges and staff has increased by less than two-thirds. Approximately one-third of the backlogged cases involve small deficiencies of $10,000 or less, which together represent about 1 percent of the total alleged deficiencies. Cases involving sums of $100,000 or more, comprising about one-fourth of the backlogged cases, make up most of the remaining deficiencies. The acceleration of case resolution, particularly corporate cases involving large sums, could substantially increase revenues for at least a decade, although it would not change the total revenues eventually collected.

Several alternatives are available for better managing the mounting backlog. One approach would be to increase Tax Court resources. Currently, the Tax Court has 38 authorized judges--24 regular judges to hear the bulk of the caseload and 14 special trial judges who deal almost exclusively with cases under $5,000 where less formal procedures have been elected. Adding six regular judges to handle cases involving more than $10,000 and four special trial judges would arrest the growth of backlogged cases and would generate about $0.1 billion in net tax collections annually. (The estimated additional receipts, including the payment of interest and penalty charges, reflect an associated acceleration of pre-trial settlements and take account of salaries and other expenses needed to expand the Tax Court and the Office of Chief Counsel at IRS.)

Proponents of expediting tax cases by simply adding more judges may disagree on how to divide them between regular and special trial judges. Adding regular judges permits focusing on large dollar cases but limits flexibility to respond to changing workloads because of requirements for authorizing legislation and presidential appointments to 15-year terms. Others, however, favor measures incorporating procedural and organizational changes--such as the creation of an administrative law board or better case management.

VI-12. REPEAL DOMESTIC INTERNATIONAL SALES CORPORATIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.9	2.0	2.5	2.7	2.9	10.9

Domestic International Sales Corporations (DISCs) are specially defined subsidiary corporations established as conduits for export sales. Export income is allocated between the parent corporation and its DISC according to one of several methods defined in the Internal Revenue Code. The DISC is tax-exempt. The parent corporation, however, is taxed at its normal rate on income distributed to it from the DISC. As long as export income is retained in the DISC, the parent corporation's tax liability is deferred. Firms are able to defer payment of tax on a maximum of 33 percent of their export income, which allows them to increase their volume of exports by lowering prices. Eliminating DISC provisions and taxing accrued deferrals over ten years would increase revenues $10.9 billion over the 1985-1989 period.

The principal objective of the 1971 legislation establishing DISCs was to increase exports as a way of improving the U.S. balance of trade and of increasing domestic employment. Treasury data on 1981 exports, the latest available, indicate they were between $7.2 billion and $11.0 billion higher than they would have been without DISC provisions, although these figures are not universally accepted. The Treasury's calculations include only the initial increase in exports resulting from DISC-supported price decreases, without the counteracting effects of adjustments in the foreign exchange markets. DISC proponents argue that these provisions are necessary to counter foreign export subsidies, raise the level of U.S. exports, and consequently increase domestic employment and income. Opponents argue that the increase in exports is purchased at an excessive cost in terms of federal revenue losses and that DISC provisions increase the danger of further international escalation of export subsidies and market distortions. Many U.S. trading partners have alleged that DISCs violate the General Agreement on Tariffs and Trade (GATT). The Administration's proposed Foreign Sales Corporation (FSC) is intended to be an export incentive that does not violate GATT guidelines. FSCs would virtually eliminate DISCs but would entail revenue losses of their own.

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VI-13. REPEAL CREDIT FOR INCREMENTAL RESEARCH EXPENDITURES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.3	0.4	*	*	*	0.8

* Less than $50 million.

The Economic Recovery Tax Act of 1981 authorized a nonrefundable 25 percent income tax credit for certain research and development (R&D) expenditures. Qualifying expenditures are limited to those that exceed the average for the three preceding taxable years; thus, the credit applies only to incremental expenditures above some approximation of the taxpayer's customary level. The credit is available only for research expenditures through the end of calendar year 1985. Repealing the credit would increase federal revenues by $0.3 billion in fiscal year 1985 and by $0.8 billion over the 1985-1989 period.

Although such a credit might well encourage increased R&D expenditures--a goal generally considered to be socially desirable--these tax incentives may be unnecessary and inefficient. First, research expenditures already have preferential treatment because they can be written off immediately; ordinarily, expenditures that generate income over several years are written off for tax purposes over a like period. Thus, the credit may not be necessary. Second, the formula used to distinguish incremental from customary expenditures creates an unfortunate incentive structure. Troubled firms may tend to lower current research spending to reduce their base-period average and thereby allow later increased spending to qualify for the credit. Firms with ongoing research can be encouraged to postpone some expenditures for the same reason. Further, new firms receive the credit for only half their expenditures, and research in a field that is new to a firm is not creditable at all. A contrary argument is that increased R&D is essential to productivity growth and that, in the absence of some more effective incentive, even an imperfect tax credit is worth maintaining.

VI-14. ELIMINATE CAPITAL GAINS TREATMENT OF TIMBER

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.3	0.7	0.8	0.8	0.8	3.4

Income from harvested timber held for at least one year before cutting is taxed at preferential capital gains rates. This special provision overrides the general denial of capital gains treatment to "stock in trade . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Otherwise any manufacturer could produce a product, put it on a shelf for one year before selling it, and have the profits taxed at a lower rate. Repealing this provision would add about $3.4 billion to federal revenues over the 1985-1989 period.

Although preferential treatment was initially extended to equalize the treatment of different timber sales--to eliminate distinctions between owners who sold cut timber and owners who sold their land with the timber standing--current law arguably promotes unequal tax treatment, inefficient investment allocation, and arbitrary administration. The provision favors vertically integrated timber firms over others and permits high-tax-rate individuals to gain from converting ordinary income into capital gains. Favorable treatment of timber induces inefficient shifts in investment allocation. Large efforts must be expended to determine "fair market value" of timber to apportion income to capital gains. Finally, the timber industry is allowed to expense and claim the investment credit for certain reforestation costs--tax benefits that might make capital gains treatment redundant.

Although the timber industry suffered heavily in the 1981-1982 recession and is pressed by foreign competition, direct subsidies for specific relief would be a less disruptive means of aiding those hardest hit. If conservation or an assured supply of timber were policy goals, again, direct incentives would more efficiently achieve those ends. But if timber taxes were to be suddenly increased, timberland owners would suffer losses because tax benefits are already capitalized in the land values. No grandfathering or other transition device could prevent this drop in the value of timberland if capital gains treatment were repealed.

VI-15. ELIMINATE TAX-EXEMPT REVENUE BONDS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Mortgage Revenue Bonds for Multiple Dwellings	*	0.2	0.4	0.6	0.9	2.2
IRBs						
Small Issues	0.1	0.6	0.9	1.0	1.1	3.7
Pollution Control	*	0.1	0.3	0.4	0.5	1.3
Other	*	0.1	0.3	0.4	0.6	1.4
Hospital Bonds	0.1	0.3	0.6	1.0	1.4	3.3
Student Loan Bonds	*	0.2	0.4	0.7	1.0	2.2
Total	0.4	1.5	2.9	4.1	5.4	14.2

* Less than $50 million.

NOTE: Totals may not add because of rounding.

In the past 20 years, state and local governments have issued more and more tax-exempt bonds, making it possible for private businesses and individuals to borrow funds at below-market interest rates. The low interest rates result from the bonds' exemption from federal taxation, which in effect constitutes a federal subsidy of the borrowing costs of private taxpaying entities. During the past 15 years, the Congress has periodically questioned the purpose of providing these subsidies and expressed concern about the revenue losses that result from the practice. If current law remains in effect, revenue losses from all private purpose bonds will amount to $11.4 billion in fiscal year 1985, rising to $16.9 billion in 1989. These bonds include mortgage revenue bonds for single-family homes and multiple dwellings, industrial revenue bonds, which lower the borrowing costs of private firms for a wide variety of purposes, private hospital revenue bonds, and student loan bonds.

Mortgage Revenue Bonds. The elimination of mortgage bonds for multiple dwellings would raise $2.2 billion over the 1985-1989 period. Under current law, the use of mortgage revenue bonds for single-family housing

ended on December 31, 1983. Legislation that would extend their use for another five years is now pending. If passed, the revenue losses from these bonds will amount to $0.2 billion in fiscal year 1985, rising to $1.4 billion in 1989, further reducing the CBO revenue baseline by $3.9 billion over the five-year period. Legislation permitting states to substitute mortgage credits for tax-exempt financing is also under consideration. It would reduce revenue losses from mortgage bonds by $0.7 billion over five years.

Industrial Revenue Bonds. IRBs include bonds for a variety of special purposes such as pollution control; airport and port facilities; industrial parks; trade show and convention centers; and so-called "small issues," which may be used for various purposes, but cannot exceed $10 million. In 1983, small issue sales amounted to an estimated $10.0 billion; the volume of pollution control bonds amounted to $4.5 billion; bonds for other purposes amounted to $4.6 billion.

IRBs finance roughly 40 percent of all private investment in pollution control equipment. Eliminating the subsidy would add $1.3 billion to federal revenues in the 1985-1989 period. Eliminating the tax exemption for small issue IRBs would raise an additional $3.7 billion over the same period. Eliminating IRBs for all purposes would raise $6.4 billion.

The use of all of these bonds has been controversial. The supporters of the bonds argue that they promote economic development. The advocates of eliminating the bonds maintain that the large business tax cuts in ERTA reduced the need for interest-cost subsidies in general. In fact, the combination of tax-exempt financing, the investment tax credit, and depreciation benefits often results in deductions that exceed expensing for several classes of equipment, and imply a negative tax on new investment.

Hospital Bonds. The use of tax-exempt bonds by nonprofit tax-exempt institutions, including nonprofit hospitals, which will account for a revenue loss of $1.7 billion in 1985, rising to $2.6 billion in 1989, has also come into question. The advocates of the bonds maintain that they lead to lower hospital costs; those who support elimination of the bonds question the need for any subsidy since the supply of hospital beds seems to be adequate. Eliminating the subsidy would raise $0.1 billion in 1985, rising to $1.4 billion by 1989. As a subsidy mechanism, tax-exempt bonds are much less efficient than direct subsidies because the benefits are shared between the borrower of funds and the investor in tax-exempt bonds. The supporters of tax-exempt financing argue that inefficiency is a poor argument in situations where the likelihood of enacting direct subsidy programs is negligible. In many instances, however, the main issue is whether the subsidy is necessary at all; efficiency is a secondary concern.

Student Loan Bonds. State agencies float student loan bonds to increase the amount of funds available for guaranteed student loans. The volume of the bonds rose from $0.1 billion in 1977 to $1.8 billion in 1982, and $3.2 billion in 1983. Revenue losses from these bonds are estimated at $3.3 billion for the 1985-1989 period. Eliminating the bonds would raise $2.2 billion over the same period. Other institutions, particularly the Student Loan Marketing Association (Sallie Mae), provide similar support without using tax-exempt bonds. But some states would argue that Sallie Mae financing has been inadequate.

VI-16. RESTRICT TAX-MOTIVATED LEASING BY NONPROFIT INSTITUTIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	1.0	1.7	3.1	4.9	5.3	16.0

In the past few years, increasing numbers of tax-exempt entities, including state and local governments and educational institutions, have used tax-motivated leasing as a financing mechanism. The tax-exempt entity sells an existing asset to private investors and immediately leases the property back for its continued use. The private investors claim all the tax benefits of ownership, including interest and depreciation deductions and investment tax credits, if applicable. In turn, the lease payments are set at a level that permits the user to share in the financial benefits of the tax deductions and credits. The same process can be used to finance the acquisition of a new asset or the rehabilitation of existing structures.

Tax-motivated leasing provides financial assistance for tax-exempt entities. Critics of the practice argue that depreciation deductions and investment tax credits were primarily intended to offset the liabilities of taxpaying entities; if these tax provisions are extended in the nonprofit sector, the only limit to the future federal revenue loss will be the capacity of private investors to purchase assets and to absorb tax deductions. Defenders of the practice argue that, in part, the investment credit and accelerated cost recovery provide a subsidy to encourage investment, which should be available to nonprofit entities and for-profit businesses alike. Other observers have noted that, if any problem exists, the solution is to scale back the depreciation benefits and tax credits enacted in ERTA rather than to distinguish between investments of taxable and tax-exempt entities.

Both houses of the Congress considered legislation in 1983 to cut back depreciation deductions and investment tax credits for property used by tax-exempt entities. If such legislation passes, it will increase federal revenues by $1.0 billion in 1985 and $16.0 billion over the 1985-1989 period.

VI-17. REPEAL THE DEDUCTION FOR EXCESS BAD-DEBT RESERVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.6	0.9	1.0	1.0	1.1	4.5

Unlike other businesses, commercial banks and thrift institutions are allowed a tax deduction for bad-debt reserves in excess of the amount they actually experience. These deductions are permanent, with no later adjustment if repayment experience proves more favorable. Banks generally may deduct 0.6 percent of the amount of their loans, whether they are risky or safe. Thrift institutions--savings and loan associations and mutual savings banks--receive a more generous deduction of up to 40 percent of their taxable income if they make a specified proportion of their loans (82 percent for savings and loans, 72 percent for mutuals) for real estate and meet certain other conditions. TEFRA reduced the value of these deductions beginning in 1983 by allowing banks and thrift institutions to claim only 85 percent of the amounts of bad debts in excess of experience.

Most taxpayers are permitted deductions for bad debts based on experience. Beginning after 1987, commercial banks will be subjected to the same treatment. If all financial institutions were prohibited from taking excess deductions after July 1, 1984, revenue gains would amount to $0.6 billion in 1985 and to $4.5 billion through 1989.

Repealing the bad-debt provision would eliminate perverse or poorly targeted incentives and subject all business losses to the same tax treatment. At present, bankers engaging in relatively risky loans get no greater deduction than others; to compensate, they may charge higher rates. Moreover, only thrift institutions have a specific incentive to make mortgage loans, and the incentive is effective only to the extent these loans help thrift institutions qualify for the tax break. Some might suggest that diversification, rather than concentration on real estate loans, would be more conducive to the thrifts' financial stability. Banks and thrifts argue that the tax break compensates them for the idle funds they are required by law to keep in reserve. The amount of the deductions, however, is not related to the actual reserve requirements, which vary by the type of financial institution and the agency by which it is regulated. Critics of repeal also contend that, with all the recent deregulatory steps in the financial sector, a period of stability is warranted.

VI-18. DISALLOW INTEREST DEDUCTIONS FOR BANK HOLDINGS OF TAX-EXEMPT SECURITIES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.2	0.5	1.0	1.4	1.9	5.0

The Internal Revenue Code permits individuals and businesses to deduct annual interest charges paid on debt incurred in producing taxable, but not tax-exempt, business income. Until 1983, however, banks were permitted to deduct interest payments made to depositors and other lenders even when these funds were used to finance the purchase of tax-free securities. A provision in TEFRA restricted this special exception to 85 percent of the interest deduction previously allowed to banks, beginning in 1983. Still, banks have a unique twofold tax benefit--an exemption on the income claimed from the securities, and a tax deduction applicable to other taxable income. Eliminating the deduction would tend to equalize treatment of business income, and would raise federal tax revenues by about $0.2 billion in 1985 and $5.0 billion through 1989.

Disallowing the interest deduction entirely would cause the tax treatment of banks to resemble more closely that of competing financial institutions, which are not allowed this deduction. At present, banks conceivably may earn an after-tax yield on tax-exempt assets roughly a third larger than competitors.

On the other hand, banks, which absorb a large portion of tax-exempt issues, might be less inclined to do so without the special deduction. This could depress the overall market for municipal bonds and lead to greater financing costs for the governments issuing them and for other users of tax-exempt bonds. The share of all tax-exempts held by banks, though, has declined to roughly a third in recent years; of new tax-exempt securities issued in 1982, bank purchases accounted for less than 10 percent.

VI-19. TREAT CREDIT UNIONS LIKE OTHER THRIFT INSTITUTIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.1	0.2	0.2	0.2	0.3	1.0

Credit unions, organized for the benefit of members and operated without profit, are not subject to federal income taxes. By exempting credit union income from tax, the tax code treats these organizations and their members more favorably than it does competing thrift institutions. Requiring that credit unions be subject to the same tax treatment as savings and loan associations and mutual savings banks would complement other regulatory changes that have lessened distinctions among providers of financial services and would raise about $0.1 billion in 1985 and about $1.0 billion through 1989.

Historically, savings and loan institutions, mutual savings banks, and credit unions had been tax-exempt because they were regarded as operating for the sole benefit of their members. In 1951, though, the tax exemptions for the first two groups were removed because they were recognized to resemble corporations more closely than mutual organizations. Today, credit unions have more than 47 million members and over $87 billion in assets--a threefold increase in the past decade alone--and are comparable in strength and services to taxable thrift institutions. Credit unions make residential loans and offer lines of credit and credit cards, blurring the distinctions between them and other savings organizations. Permitting the passthrough of income to credit union members with no tax at the "corporate level" gives credit unions a cost advantage. This is contrary to the intent of deregulation of the financial services sector--which was to eliminate preferences.

Taxing credit unions in the same manner as other thrifts would place all financial institutions on a more equal footing and eliminate any competitive advantage that credit unions derive from escaping taxation. On the other hand, although the array of credit union services overlaps with those of taxable financial institutions, credit unions claim their fundamentally different organizational structure justifies the tax exemption.

VI-20. LENGTHEN BUILDING DEPRECIATION FROM 15 TO 20 YEARS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.3	1.3	2.5	3.6	4.9	12.6

The Economic Recovery Tax Act shortened the depreciation period for buildings from about 30 years to 15 years. Most buildings are actually used well in excess of 30 years and therefore can be fully depreciated several times if resold. Lengthening the depreciation period to 20 years would raise revenues by $12.6 billion from 1985 through 1989.

Shortening a building's tax life bunches depreciation deductions into the early years of ownership, thereby allowing investors to show large tax losses that can be used to shelter other income from tax. Later, the building can be sold, and the excess of the sale price over the depreciated value (using straight-line depreciation) will be taxed only at the capital gains rate.

ERTA is estimated to have raised the value of typical real estate tax shelter investments by 30 to 50 percent. The result has been a mushrooming of such tax shelters. Annual public sales of real estate partnerships quadrupled in the first three years of ERTA--from $1 billion in 1980 to an estimated $4 billion in 1983. Statistics on the growth of private partnerships are lacking, but firms monitoring private partnerships report their activity has also spurted recently. The growth of real estate tax shelters has far exceeded the growth in private building; that construction is up by just 20 percent.

The rapid growth in real estate tax shelters indicates to many that depreciation lives may be too short. A lengthening of useful lives, say to 20 years, would limit tax shelters. On the other hand, supporters of ERTA's speeded depreciation hold that it increases construction activity, raises employment, and provides more and cheaper rental housing. They view the growth of tax shelters as evidence that ERTA's incentives are having their desired effects.

VI-21. REPEAL REDUCED RATES ON THE FIRST $100,000 OF CORPORATE INCOME

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	4.8	8.7	9.4	9.8	10.1	42.8

Under current law, corporate income is generally subject to a flat statutory tax rate of 46 percent, but corporate taxable income under $100,000 is subject to lower tax rates according to the following schedule:

Taxable Income (dollars)			Marginal Tax Rate (percent)
0	to	25,000	15
25,000	to	50,000	18
50,000	to	75,000	30
75,000	to	100,000	40

The reduced rates are intended to provide tax relief for smaller businesses and to reduce the disparity in tax rates between corporations and businesses operated as partnerships or sole proprietorships, which are taxed under the individual income tax. They may also enhance competition by making it easier for smaller firms to enter markets dominated by large companies.

The reduced rates are criticized as inefficient in achieving these objectives because they are available to all corporate taxpayers, not just small firms. Corporations that earn more than $100,000 in taxable income save $20,250 because of the reduced rates. Generally, there is no necessary relationship between the size of a corporation and the income (or wealth) of its shareholders. Thus, the benefits of the reduced rates do not necessarily accrue to lower-income taxpayers. Furthermore, many persons in high tax brackets have an incentive to incorporate their activities to take advantage of the lower rates. For them, the corporate form of ownership may be advantageous from a tax standpoint relative to a partnership or sole proprietorship. Repeal of this provision would raise $4.8 billion in 1985 and $42.8 billion between 1985 and 1989.

VI-22. REQUIRE FULL BASIS ADJUSTMENT FOR THE INVESTMENT TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.4	1.5	2.8	4.1	5.5	14.3

Taxpayers are allowed tax credits for certain investments--for example, general machinery and equipment or energy conservation equipment. The credit for property with a five-year tax life (which includes most equipment investment) is 10 percent, effectively reducing the acquisition cost to the investing firm to 90 percent of the market price. (The investment credit for three-year property is 6 percent, reducing its cost to 94 percent of the price.) Before TEFRA, firms were allowed to depreciate 100 percent of an asset's price according to prescribed schedules. Thus, they received two overlapping tax benefits for the same investment: a credit paying 10 percent of the asset's cost, and depreciation deductions for that 10 percent as well as the other 90 percent of the cost of the asset.

This overlap could be avoided through a "basis adjustment" that would reduce the depreciation deductions by the amount of the credit. Such a basis adjustment was required when the regular investment tax credit was enacted in 1962, but was repealed after two years. TEFRA reduced the depreciable basis of an asset by 50 percent of the eligible credit; thus, in the case of the regular 10 percent credit, firms may now depreciate only 95 percent (97 percent for three-year property) of an asset's price. A full basis adjustment would restrict depreciation to the firm's net cost of the asset--90 percent in the case of the regular investment credit. This proposal, if applied to the regular investment credit for machinery and equipment, would raise $0.4 billion in 1985 and $14.3 billion in 1985-1989.

The allowance of overlapping depreciation deductions and tax credits is a subsidy that encourages investment in equipment, thereby enhancing the competitiveness of U.S. industry. It has, however, been criticized as overly generous. The double benefit results in effective corporate tax rates close to zero on income generated by new equipment when inflation is 6 percent and the real interest rate is 4 percent. A 100 percent basis adjustment would result in effective corporate tax rates of between 5 and 20 percent on most new equipment, well below the statutory tax rate of 46 percent.

VI-23. LIMIT REHABILITATION TAX CREDITS TO HISTORIC BUILDINGS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.2	0.4	0.5	0.6	0.7	2.4

The Congress has enacted large tax credits for amounts spent rehabilitating older income-producing buildings. The credits were designed to encourage businesses to renovate their existing premises rather than relocate, to encourage people to purchase and put to new use older buildings that have outlived their original purposes, and to encourage the preservation of historic buildings. The credits range from 15 to 25 percent, depending on the age of the building and whether it is registered with the Department of the Interior as an historic structure. Retaining only a 15 percent credit for certified historic renovations would save $0.2 billion in 1985 and $2.4 billion over the 1985-1989 period.

The current tax credits are so large that they seem certain to promote a great deal of renovation if interest rates fall and the economy continues to recover. Many owners, however, will receive large tax savings for doing what they would have done even if the credits did not exist or were not so large. Moreover, since the credits are available for rehabilitation of commercial buildings only and not for rental housing (with the exception of housing in historic buildings), they will promote the conversion of some structures to commercial use and generally draw investment funds away from rental housing. They will similarly draw some funds away from new construction that could have contributed more to the efficient operation of the economy than the renovation that takes its place.

The credit does protect against the destruction of older, historically noteworthy or architecturally distinguished buildings. Retaining a credit just for renovation of certified historic buildings would limit the tax loss to projects clearly preserving historic buildings. Preliminary surveys indicate a 15 percent credit would be sufficient to cover the extra costs of certification and historic-quality rehabilitation. And limiting the credit to historic buildings would remove the incentive to convert older rental housing to commercial use. If the historic renovation credit also were eliminated, revenue gains could be boosted by an added $0.1 billion in 1985 and $2.2 billion over the 1985-1989 period.

VI-24. REPEAL THE TAX CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	1.3	2.2	2.3	1.0	*	6.8

* Less than $50 million.

An Employee Stock Ownership Plan (ESOP) buys and holds a firm's stock for its employees. In a tax-credit ESOP, the employer contributes stock, or cash to buy stock, and can claim a tax credit for the contribution. The full value of the contribution is a credit against taxes, unlike other employer wage and benefit costs, which are only deductions from income. The credit is capped at 0.5 percent of the firm's payroll in 1984, rising to 0.75 percent in 1985. The ESOP holds the stock and dividends in a tax-free trust for the employees, who pay no tax themselves until they terminate employment and liquidate their share of the stock. The Congress first enacted the ESOP tax credit in 1975 for a two-year trial; it since has been extended and modified several times and now is due to expire in 1987. Repealing the tax credit in January 1985 and making ESOP contributions deductible like other fringe benefits would increase revenues by $6.8 billion over the 1985-1989 period.

The prime benefit of the tax credit is that it strongly encourages corporations to set up and contribute to ESOPs. Because ESOPs give employees an ownership interest in their firms, ESOPs may improve employee motivation and raise productivity. ESOPs with large stock holdings could also broaden the ownership of corporate wealth, supplement retirement income, and strengthen political support for private enterprise. The prime objection to the tax credit is on grounds of equity. Through the tax credit, the government in effect buys stock and gives it to trusts for particular individuals. The stock gifts are unavailable to others, such as the self-employed and employees of unincorporated or nonprofit businesses.

VI-25. INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Increase
Impose Tax on Domestic and Imported Oil ($2 per barrel)	5.7	8.3	8.4	8.4	8.5	39.3
Impose Oil Import Fee ($2 per barrel)	2.5	3.7	3.5	3.6	3.7	17.0
Impose Excise Tax on Natural Gas (30 cents per 1,000 cubic feet)	2.6	3.8	3.7	3.7	3.7	17.5
Increase Gasoline Excise Tax (5 cents per gallon)	3.2	4.4	4.4	4.4	4.3	20.7
Impose Broad-Based Tax on Domestic Energy (5 percent of value)	10.7	16.1	17.3	18.6	20.2	82.9

NOTE: These added revenues are net of any estimated changes in corporate, windfall profit, or other taxes that might result from each option. Induced outlay effects were not estimated.

Energy taxes could raise significant amounts of revenue, reduce the country's dependence on foreign oil suppliers, and increase conservation by making energy more expensive. The United States depends on foreign sources for about 30 percent of the oil it consumes, and about 10 percent of its total energy. It has been argued that this dependence involves risks to the U.S. economy--the most dangerous being potential supply disruptions and their economic and political consequences. Reducing energy consumption by using energy taxes may reduce the costs of supply interruptions and increase the flexibility of U.S. foreign policy.

In addition, it has been argued that energy taxes will increase conservation efforts (over and above those consistent with normal market prices). Thus, energy taxes offer incentives for further reducing energy consumption, thereby prolonging the availability of this country's nonrenewable energy resources. Further, some have argued that energy taxes are needed to capture some of the windfall profits or rents associated with high energy prices.

Several concerns, however, have been expressed over the use of energy taxes. Because energy taxes might raise energy prices, they may more heavily burden low-income taxpayers who spend a relatively high percentage of their income on energy. As energy use varies across different geographic regions, energy taxes could have widely different effects on firms and households in different parts of the country. In addition, to the extent that energy taxes might raise the Consumer Price Index, indexed federal outlay programs would be affected.

Five different energy taxes with varying economic and budgetary effects are considered below.

Impose Excise Tax on Domestic and Imported Oil

An excise tax on all oil--both domestically produced and imported--could raise substantial revenue. A $2-per-barrel tax starting in 1985 would raise $5.7 billion in 1985 and $39.3 billion over the 1985-1989 period. (In its budget for fiscal year 1984, the Administration proposed a $5-per-barrel contingency tax on both domestic and imported oil starting in 1986.) A $2-per-barrel tax would be equal to about 7 percent of the price of a barrel of oil or 5 cents per gallon of gasoline.

A comprehensive tax on oil would raise prices, thereby increasing conservation efforts and reducing consumption. Because the tax would apply to both foreign and domestic oil, there would be an incentive to reduce consumption from both sources. Producers (both foreign and domestic) would bear any part of the tax that they were unable to pass through to consumers. This could occur if there was excess supply in the market, or if consumers had readily available alternative energy sources such as natural gas or coal.

Impose Oil Import Fee

As an alternative to a broad excise tax on all oil, the Congress could limit the tax to imports of crude petroleum and petroleum products. An oil

import fee of $2 per barrel would raise nearly $4 billion a year. About one-quarter of that amount would come from higher oil windfall profit taxes, since an import fee would allow the price of all domestically produced oil to increase, thereby increasing the windfall "profit" and tax on each barrel.

An oil import fee, like a tax on all oil, would heighten conservation incentives by pushing up the price for all imported and domestically produced energy sources. Moreover, an oil import fee could be an appropriate source of revenue for the Strategic Petroleum Reserve, insofar as the Reserve is designed to reduce the potential consequences of oil supply interruptions. Unlike a tax on all oil, however, an oil import fee would provide an incentive to increase domestic production of oil, because the fee would raise the profitability of increased domestic production. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased as U.S. energy sources were depleted faster.

With the world price of oil currently at about $29 per barrel, the $2 fee would leave the total price of oil well below its $39-per-barrel peak in the winter of 1981. Furthermore, if there were excess supplies of crude oil on the world market, part of the fee could be borne by foreign suppliers.

Impose Excise Tax on Natural Gas

Price controls on most of domestically produced natural gas are due to be lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA), though an estimated 35 percent to 40 percent will remain regulated and subject to price controls. Economists generally agree that the price controls under NGPA have led to an inefficient allocation of natural gas. In addition, because of "take-or-pay" contracts negotiated by pipeline companies (which require them to pay gas producers for high-priced gas whether or not there is consumer demand for it), the market for natural gas is not currently functioning efficiently. Indeed, there have been relatively large price increases during a period of excess supply, and low-cost gas has been held off the market. To a large extent, however, these short-run distortions in the market would eventually be eased by decontrol. Although full decontrol in 1985 would not raise the average national price paid for natural gas, it would raise prices for selected areas served by low-cost pipelines.

Full decontrol of all natural gas could result in large windfall profits for producers of low-cost gas. The Congress may want to tax this windfall as it did that on oil. Depending on how it was structured, such a tax could raise $5 billion in the first full year. To the extent gas windfall profits from

decontrol were temporary, such a tax would provide only a short-term reduction in the deficit. Moreover, taxing the profits of gas producers could reduce dramatically any potential supply response accruing to decontrol.

An alternative that would raise revenue on a long-term basis would be a simple excise tax on natural gas, unrelated to any calculation of windfall profits. An excise tax of 30 cents per 1,000 cubic feet, for example, would raise about $3.5 billion to $4.0 billion annually. Such an excise tax would encourage conservation of gas or conversion to oil, coal, or other fuels. To the extent that gas users shifted to oil, however, dependence on imports could increase; and while switching to coal would not increase oil consumption, it might impose additional environmental costs. Therefore, a tax on natural gas might not be consistent with other energy policy goals.

Increase Gasoline Excise Tax

The Surface Transportation Assistance Act of 1982 increased the federal tax on gasoline by 5 cents per gallon in April 1983; it had been 4 cents per gallon since 1959. This increase did not reduce the deficit, however, because expenditures on construction and improvement of highways, bridges, and mass transit facilities were increased at the same time. State governments also impose gasoline taxes ranging from 5 to 18 cents per gallon.

An increase in the federal excise tax on gasoline and diesel fuel would raise about $0.9 billion per year for each 1 cent of tax. Since the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $1.22 in November 1983, raising the tax by 5 cents per gallon would not put the total cost above what consumers have recently experienced. Furthermore, such an increase would leave total federal taxes at about 12 percent of the pump price of leaded regular; in 1959 the tax represented 13 percent of the price.

Beyond raising revenue, an excise tax increase would reduce gasoline consumption and dependence on foreign oil by encouraging people to drive fewer miles or purchase more fuel-efficient cars. The excise tax would probably not significantly affect oil consumption for other purposes, such as electricity production or home heating.

Impose Broad-Based Tax on All Energy

Instead of placing selective excise taxes on various types of energy, the Congress could impose a broad-based tax on all forms of energy use. A

national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. It would probably not decrease oil consumption as much as an oil import fee or an oil tax of equal revenue, nor would it provide incentives for consumers to switch to forms of energy other than oil. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise about $15 billion to $20 billion a year in revenues. Because it would apply to all energy sources, the tax could raise much more revenue at a lower tax rate than the selective taxes discussed above.

A national energy tax alternatively could be based on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content--in British thermal units--of the fuel (Btu tax). Depending on how the tax was structured, the relative prices of the various forms of energy could be left unchanged or substantially altered. For example, a uniform Btu tax would raise the price of coal by a larger percentage than that of oil or natural gas, because a dollar's worth of coal currently buys more Btu's. Coal sells for about one-quarter of the price of oil per Btu. A national tax on energy could be collected at the point of production or importation, or at the wholesale level if that was administratively more convenient.

VI-26. REPEAL PERCENTAGE DEPLETION ALLOWANCE AND EXPENSING OF INTANGIBLE DRILLING COSTS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Repeal Percentage Depletion Allowance	0.6	1.1	1.2	1.3	1.3	5.5
Repeal Expensing of Intangible Drilling Costs	3.1	5.4	5.1	5.0	4.9	23.5

Under standard accounting practices, the cost of acquiring or improving an asset is deducted over several years through depreciation (in the case of plant and equipment) or depletion (in the case of mineral resource properties). Capital costs that are allocated over future years are referred to as "capitalized" expenditures. Producers of oil and gas, however, are allowed to deduct the amount they spend on "intangible drilling costs" (expenses such as fuel, labor, and supplies used in drilling and preparing wells) in the year the expenditure is made--that is, they may "expense," rather than "capitalize," these asset-related costs. When these costs are expensed rather than capitalized, taxes on income are deferred to future years; this is tantamount to an interest-free loan in the amount of the delayed tax liability.

Many other costs related to oil and gas wells are capitalized and recovered through either depreciation or cost depletion. Tangible equipment, such as pumps or meters, is capitalized and is subject to the depreciation rules of the accelerated cost recovery sytem (ACRS). Costs associated with acquiring mineral rights or exploration (such as geological surveys) are also capitalized, and recovered through cost depletion. Under cost depletion, firms are allowed to deduct a percentage of mineral acquisition costs that equals the percentage of estimated total reserves produced in a given year.

In contrast, "independent" oil companies are allowed to use percentage depletion instead of cost depletion. (An independent oil company is one that is almost exclusively engaged in the production phase of the petroleum business; it cannot have significant retail or refining operations.) Percentage depletion allows these companies to deduct 15 percent of the gross oil and

gas revenue from their income each year, regardless of how much was paid to acquire the mineral rights. It is common for independent oil companies to write off more than the cost of producing properties over their useful lives through use of percentage depletion. Percentage depletion is currently limited to 1,000 barrels of production per day; at a price of $29 per barrel of oil, producers can take percentage depletion on gross revenues of up to $10.6 million per year.

Under TEFRA, the Congress limited expensing to 85 percent of intangible drilling costs; the remaining 15 percent must be written off over a 36-month period. This limitation applies only to integrated oil companies, however; the independent companies are still allowed full use of the deduction. The value of the allowance for percentage depletion has also been reduced: the applicable rate has fallen from 22 percent in 1980 to 15 percent in 1984, and the deduction is subject to the add-on minimum tax.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic oil production. Furthermore, the oil and gas industry is highly risky, especially for small firms, and favorable tax treatment may be required so that firms can raise sufficient capital. Advocates also argue that, with the substantial liberalization of depreciation allowances and investment tax credits, many other forms of equipment and machinery now receive tax treatment that is as favorable as oil and gas capital investment, if not more so. Relative to five-year ACRS property, expensing of drilling costs or percentage depletion may no longer provide any preferential tax advantage. If account is taken of the windfall profit tax on oil, investment in the oil industry may even be relatively disadvantageous compared to other industries.

Proponents of repeal argue that the inherent subsidy provided by the two provisions is no longer needed in light of the sharp increase in oil and gas prices in the last ten years. Full decontrol of oil and new natural gas allows prices to provide the appropriate incentives for oil and gas producers; since 1973, oil prices have risen by 227 percent and natural gas prices by 475 percent in real terms. Moreover, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

Repeal of percentage depletion would raise $0.6 billion in 1985 and $5.5 billion between 1985 and 1989. Requiring firms to capitalize all their intangible drilling costs would raise $3.1 billion in 1985 and $23.5 billion over the 1985-1989 period.

VI-27. REPEAL ENERGY TAX INCENTIVES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Repeal Residential Credits	0.1	1.0	0.1	0	0	1.2
Repeal Business Tax Incentives	0.3	0.3	0.3	0.3	0.3	1.5
Total	0.4	1.3	0.4	0.3	0.3	2.7

Repeal Residential Credits

The Energy Tax Act of 1978 provided homeowners and renters a tax credit of 15 percent of the first $2,000 spent to conserve energy. The credit applies only to principal residences built before 1977, and the cumulative credit per taxpayer for any one residence cannot exceed $300. The credit is due to expire at the end of 1985. The same legislation also established a larger credit for the installation of solar, geothermal, wind, or other renewable energy equipment in a taxpayer's residence between April 20, 1977, and December 31, 1985. Two years later, the Crude Oil Windfall Profit Tax Act of 1980 raised the renewable energy source credit to 40 percent of the first $10,000 spent, for a maximum credit of $4,000 on any one residence.

Of the amount spent under the conservation credit in 1981, 87 percent was for insulation and storm windows or doors, and 94 percent of the amount spent under the renewable energy source tax credit was for solar energy equipment. Advancing the date of expiration for both of these credits to December 31, 1984, could increase federal revenues by about $0.1 billion in 1985 and $1.2 billion over the 1985-1989 period.

Although the residential energy credits do reduce the cost of conservation investments, a Congressional Research Service study finds little evidence that the credits caused greater conservation. (Salvatore Lazzari, An Economic Evaluation of Federal Tax Credits for Residential Energy Conservation, Congressional Research Service, Rept. 82-204E, December 2, 1982.) The study attributes most residential energy conservation in the last few years to rising energy prices.

Repeal Business Energy Tax Incentives

The Energy Tax Act of 1978 and the Windfall Profit Tax Act of 1980 established a series of business tax incentives for conservation and alternative energy production facilities. Most of the credits expired on December 31, 1982, although several have December 31, 1985, expiration dates, such as the credits for solar and wind equipment, technology for geothermal and ocean thermal energy production, machinery to burn and convert biomass, and small-scale hydroelectric facilities. One conservation tax incentive, the 10 percent investment tax credit for intercity buses, also expires on December 31, 1985. Although formally expiring in 1985, some of these credits have lengthy carryover rules. In addition, tax-exempt industrial development bonds may be issued to finance facilities that produce steam or alcohol from solid waste. Two credits with longer-run effects on the federal budget are the alternative fuel production credit and the alcohol fuel tax credit and excise exemption. Terminating all these provisions as of December 31, 1984, would raise $0.3 billion in 1985 and $1.5 billion over the 1985-1989 period.

The major argument in favor of these subsidies is that they promote use of energy resources other than oil and thereby lessen dependence on foreign suppliers. This incentive is over and above that provided by normal market prices. The main objection to these energy credits is that market prices for oil and gas are a sufficient incentive for businesses to develop other forms of energy; additional credits tend to channel investment into alternatives that would not otherwise be economic.

VI-28. INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1985	1986	1987	1988	1989	Cumulative Five-Year Addition
Extend TEFRA Increase of Cigarette Excise Tax	0	1.8	1.9	1.9	2.0	7.6
Extend TEFRA Increase of Telephone Excise Tax	0	1.2	2.0	2.2	2.4	7.8
Double Excise Taxes on Alcohol	2.6	3.8	4.0	4.1	4.1	18.6
Extend TEFRA Increases on Air Travel Excise Taxes	0	0	0	1.8	3.1	4.9

The major federal excise taxes, other than those levied on gasoline and windfall oil profits, are on alcohol, tobacco, and telephone use. Several other excise taxes support the Airport and Airway Trust Fund. Additional revenues could be raised by extending the temporary increases in the tobacco, telephone, and air travel excise taxes enacted in the Tax Equity and Fiscal Responsibility Act of 1982 and by increasing alcohol excise taxes.

Cigarettes

TEFRA increased the excise tax on cigarettes from 8 cents per pack to 16 cents per pack for the period from January 1, 1983, to September 30, 1985. Extending this increase would add about $1.9 billion dollars per year to federal revenues net of reduced income taxes. The 16 cent tax represents 20 percent of the current gross cost per pack, significantly less than the 37 percent of the cost that the 8 cent tax represented when it was set in 1951.

The TEFRA increase could be seen as compensation for the social costs of smoking, including medical costs that society in general ultimately bears. The tax may also discourage smoking to a limited degree, with its

greatest impact probably on the young. On the other hand, it may not be appropriate for the government to try to manipulate consumer choice in this way.

Telephone Service

TEFRA raised the excise tax on local and long-distance telephone service and teletypewriter exchange service to 3 percent for calendar years 1983 through 1985, when it is scheduled to expire. Extending the tax beyond 1985 at the 3 percent rate would raise net revenues by $7.8 billion over fiscal years 1986-1989.

Opponents of the extension argue that telephone service is a necessity and thus the tax cannot be justified as a luxury tax. Nor does the tax fall into one of the three categories normally used to justify excise taxes: user fees, regulatory taxes, or sumptuary taxes. Opponents argue further that the tax is regressive in that it consumes a larger share of lower incomes, and that it is an arbitrary business tax with those firms that rely more heavily on telephones bearing a larger share of the burden. There is some concern that the tax limits expansion and innovation in the telecommunications industry.

Proponents of extending the tax maintain that it has had no discernible adverse impact on the growth and competitiveness of the industry. They argue that the tax has a broad base since virtually all households have telephones and that the cost to the government of administering the tax is low. Proponents believe that eliminating the tax in a period of record deficits is undesirable.

Alcohol

The tax of $10.50 per gallon on distilled spirits has not been changed since 1951. Doubling the tax to $21.00 per gallon would raise $11.4 billion in revenues (net of reduced income taxes) over 1985-1989. In 1951, $10.50 per gallon represented 43 percent of the average product price; doubling the tax would put it at a comparable percent of the average current price.

Nondistilled beverages--beer and wine--are also still taxed at the per-unit rates in effect in 1951. Doubling beer and wine excise taxes would raise about $7.2 billion in net new revenues over the 1985-1989 period. It may be desirable to coordinate the taxes on different alcoholic beverages, either in terms of the percentage of retail cost or the tax per unit of

alcohol. Currently beer and wine are both taxed at a significantly lower rate than distilled spirits, with wine receiving the most favorable treatment.

Proponents of increased taxes on alcoholic beverages argue that the increases are necessary to bring the tax rates into line with historic rates, and that the increases are needed to offset the social costs of drinking (such as those from alcoholism and alcohol-related automoble accidents). Opponents argue that tax rates on alcoholic beverages would be unjustifiably higher than those on other goods that impose social costs. In addition, increases in the federal tax rates would be interference with a tax base tapped by many of the states.

Air Travel

Excise taxes on passenger tickets, air freight, international departures, and aviation fuels fund the Airport and Airways Trust Fund, which finances federal expenditures for airport capital improvements and a portion of the airway system's operating costs. TEFRA increased some and reimposed others of these taxes, leaving them to expire on December 31, 1987. Extending the TEFRA excise tax increases through 1989 would increase net revenues by $4.9 billion from 1985 to 1989. (Other options affecting this program are discussed in Option V-19.)

Proponents maintain that extension of these taxes is necessary to continue to fund federal expenditures on airport construction and the air system's operating costs. Allowing air travel excise taxes to expire would result in shifting the burden for these services to the general public rather than continuing the user-pay principle. Opponents argue that the current trust fund balance plus projected receipts under current law are more than sufficient to meet the authorized spending levels. In addition, they argue that the level of air travel excise taxes should be determined solely by the exigencies of the Airport and Airways Trust Fund and not by concern over the level of the budget deficit.

VI-29. FREEZE ESTATE AND GIFT CREDIT AND TAX RATES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0	0.9	1.7	2.5	3.1	8.2

The Economic Recovery Tax Act of 1981 substantially reduced taxes on estates and gifts over a six-year phase-in period. It provided for a credit that effectively exempts all estates of under $325,000 from the estate tax in 1984. By 1987, all estates worth less than $600,000 will be exempt. The act also reduced the maximum tax rate from 70 percent to 50 percent over a four-year period; it will be 55 percent in 1984 and 50 percent in 1985. Freezing the credit and tax rate at their 1984 levels would increase revenues by $8.2 billion over the 1985-1989 period.

Further reductions in estate and gift taxes can be criticized on several grounds. The reductions in ERTA were adopted as a way to offset the effects of inflation and provide tax relief to small- or moderate-sized estates, especially those that consist of family businesses. As the rate of inflation has been less than forecast when ERTA was passed, the value of the reductions is now substantially more than estimated in 1981. Further, according to 1979 data, only about 3.5 percent of those dying at age 45 and over had estates valued at more than $250,000. Any extension of the credit thus applies to only a relatively small percentage of wealthy taxpayers.

Some argue that estates should not be taxed because they have already been subject to the income tax during the accumulation process. Large estates, however, often consist of unrealized capital gains (for example, corporate stock or housing). When assets are transferred at death, the heir does not pay capital gains taxes on any increase in value occurring before the owner's death; accrued appreciation will go untaxed if it is also exempt from the estate tax. In this way, unrealized capital gains may never be taxed. In 1979, 25 percent of the value of gross estates over $300,000 consisted of unrealized capital gains appreciation--over 50 percent derived from corporate stock. Thus, freezing the estate tax credit and maximum tax rate would strengthen the only tax on capital gains at death. On the other hand, it has been argued that low estate and gift taxes are necessary to encourage individuals to engage in risky, entrepreneurial activities.

APPENDIXES

APPENDIX A. SUMMARY TABLES OF SPENDING AND TAXATION OPTIONS BY BUDGET FUNCTION

The preceding pages of this report contain 138 deficit reduction options that are specific to particular federal programs or to provisions of the Internal Revenue Code. The tables that follow list those options by budget function. When an option affects several functions, it is assigned to the function on which it has the largest impact. Some spending options affect all functions, and some taxation options cannot be classified by function at all; options of this kind are carried at the end of the tables.

Table A-1 lists spending reduction options and Table A-2 taxation options. The page number in parentheses after the caption for each item locates the discussion of that item in the body of the report.

For each option, the tables display the estimated 1985-1989 savings or revenue gains that would result from its enactment. Both budget authority and outlay savings are shown for the spending reduction options. The estimates do not include any secondary effects--that is, effects on spending or revenues that would occur if the performance of the economy as a whole were altered by enacting the options shown here.

Unless specified otherwise, the estimates assume the proposals in Table A-1 take effect on October 1, 1984, and those in Table A-2 on January 1, 1985. The separate options cannot be added to a grand total. Some are mutually exclusive; some overlap with others; and in some cases there are interactions, so that if several options were enacted together the combined savings would differ from the total of those estimated for each option separately.

TABLE A-1. ILLUSTRATIVE SAVINGS IN BUDGET AUTHORITY AND OUTLAYS FROM CBO BASELINE SPENDING PROJECTIONS, BY BUDGET FUNCTION, FISCAL YEARS 1985-1989 (In millions of dollars)

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
050 National Defense						
Cancel the Army Helicopter Improvement Program **(II-1, p. 25)**						
Budget Authority	300	300	500	600	500	2,200
Outlays	40	150	300	400	500	1,400
Cancel the LANTIRN Program **(II-2, p. 26)**						
Budget Authority	300	500	500	700	700	2,800
Outlays	80	200	350	500	600	1,700
Cancel C-17 Program **(II-3, p. 27)**						
Budget Authority	100	400	700	3,100	3,500	7,800
Outlays	80	300	400	1,300	2,200	4,300
Cancel C-5 Program **(II-3, p. 27)**						
Budget Authority	2,600	3,000	2,700	--	--	8,200
Outlays	300	1,500	2,300	2,200	1,100	7,400
Freeze Annual Procurement of the F-15 at 36 **(II-4, p. 29)**						
Budget Authority	600	1,100	1,600	2,800	2,600	8,700
Outlays	70	400	800	1,400	2,100	4,800

NOTE: An asterisk in this table indicates less than $2.5 million.

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
050 National Defense						
Cancel the F-15 **(II-4, p. 29)**						
Budget Authority	1,200	2,100	3,300	4,600	4,400	15,700
Outlays	100	800	1,600	2,700	3,700	8,900
Terminate Production of the A-6 Bomber **(II-5, p. 31)**						
Budget Authority	250	--	--	--	--	250
Outlays	40	100	70	20	9	239
Suspend Production of F-14, Proceed With Upgrade **(II-6, p. 32)**						
Budget Authority	700	1,300	800	700	300	3,800
Outlays	90	500	900	900	700	3,000
Limit Production Increases of the MX Missile **(II-7, p. 33)**						
Budget Authority	1,600	1,600	1,500	1,600	-1,000	5,300
Outlays	300	900	1,300	1,400	1,000	4,900
Limit Production of the M2 Bradley Fighting Vehicle **(II-8, p. 34)**						
Budget Authority	200	400	500	500	400	2,000
Outlays	10	100	300	400	500	1,300

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
050 National Defense						
Reduce Construction of New Submarines and LSDs While Extending the Service Life of Existing Ships **(II-9, p. 35)**						
Budget Authority	1,100	1,100	1,300	1,400	1,500	6,500
Outlays	70	200	400	700	900	2,400
Defer Development of the DDG-51 and Accelerate Procurement of CG-47 Class Ships **(II-10, p. 36)**						
Budget Authority	200	-1,100	2,000	2,500	2,600	6,200
Outlays	10	-40	-10	300	700	1,000
Reduce One Army Division to Cadre Status **(II-11, p. 38)**						
Budget Authority	50	200	300	300	300	1,100
Outlays	40	100	200	200	200	700
Slow Tactical Air Force Increases **(II-12, p. 40)**						
Budget Authority	100	400	500	500	600	2,100
Outlays	70	230	370	440	500	1,600

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
050 National Defense						
Reduce COLAs for Working-Age Military Retirees (II-13, p. 41)						
Budget Authority	3,730	4,030	4,330	4,640	4,970	21,700
Outlays	-120	140	640	960	1,270	2,880
Limit the Military Pay Raise (II-14, p. 43)						
Budget Authority	900	1,300	1,400	1,500	1,600	6,700
Outlays	600	900	1,000	1,000	1,100	4,700
Impose Outpatient Fee at Military Medical Facilities (II-15, p. 45)						
Budget Authority	165	170	170	170	170	845
Outlays	165	170	170	170	170	845
Restore Previous Officer/ Enlisted Ratios (II-16, p. 46)						
Budget Authority	90	300	600	800	900	2,700
Outlays	60	200	400	600	600	1,900
Reduce Navy Active-Duty Manpower Assigned to Shore Duty (II-17, p. 48)						
Budget Authority	40	100	200	300	300	1,000
Outlays	20	80	100	200	200	600

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
050 National Defense						
Limit Real Growth Increases in DoD Research and Development **(II-18, p. 50)**						
Budget Authority	2,400	2,600	2,700	3,100	3,300	14,100
Outlays	1,300	2,300	2,600	2,800	3,100	12,100
Freeze for One Year Real Growth in "Supporting" Procurement **(II-19, p. 52)**						
Budget Authority	3,000	3,300	3,600	3,900	4,300	18,100
Outlays	200	1,300	2,400	3,100	3,600	10,600
Slow Growth in Operations and Maintenance Spending **(II-20, p. 53)**						
Budget Authority	2,500	2,800	3,200	3,400	3,800	15,700
Outlays	2,000	2,700	3,100	3,300	3,700	14,800
150 International Affairs						
End EXIMBANK Direct Loan Program **(V-4, p.143)**						
Budget Authority	1,850	2,500	2,700	3,000	2,200	12,250
Outlays	200	900	1,700	2,200	2,400	7,400

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
150 International Affairs						
Eliminate Cargo Preference for Nonmilitary Shipments (V-5, p. 144)						
Budget Authority	150	150	160	160	170	790
Outlays	150	150	160	160	170	790
Eliminate U.S. Contribution to United Nations Development Program (V-32, p. 176)						
Budget Authority	170	180	190	190	200	930
Outlays	120	170	180	190	200	860
Reduce Economic Support Fund Spending (V-33, p. 177)						
Budget Authority	310	320	340	350	370	1,690
Outlays	170	210	250	280	320	1,230
250 General Science, Space and Technology						
Increase Charges for the Space Shuttle (V-31, p. 175)						
Budget Authority	70	180	340	450	560	1,600
Outlays	70	180	340	450	560	1,600

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
270 Energy						
Raise Interest Rates on REA Loans (V-3, p. 142)						
Budget Authority a/	0	65	120	180	240	605
Outlays a/	0	65	120	180	240	605
End Credit Subsidies to the Bonneville Power Administration (V-22, p. 166)						
Budget Authority	0	-5	-10	-10	-10	-35
Outlays	430	240	260	260	290	1,480
Abolish the Synthetic Fuels Corporation (V-28, p. 172)						
Budget Authority	0	0	0	0	0	0
Outlays	0	5	5	5	5	20
Eliminate Commercially Oriented Energy Development (V-30, p. 174)						
Budget Authority	600	830	860	900	930	4,120
Outlays	320	670	820	880	910	3,600

a. Off-budget.

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
300 Natural Resources and Environment						
Raise Federal Irrigation Water Prices **(V-23, p. 167)**						
Budget Authority	20	40	60	90	120	330
Outlays	20	40	60	90	120	330
Increase User Fees for the Inland Waterways **(V-24, p. 168)**						
Budget Authority	570	580	600	630	660	3,040
Outlays	570	580	600	630	660	3,040
Levy User Fees for Ports and Harbors **(V-25, p. 169)**						
Budget Authority	500	520	540	560	580	2,700
Outlays	500	520	540	560	580	2,700
350 Agriculture						
Reorient Agricultural Commodity Price Support Policy **(IV-21, p. 125)**						
Budget Authority	0	7,750	9,000	10,600	13,600	40,950
Outlays	0	7,750	9,000	10,600	13,600	40,950
Eliminate the Honey Price Support Program **(IV-22, p. 126)**						
Budget Authority	0	40	40	40	40	160
Outlays	0	40	40	40	40	160

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
350 Agriculture						
Eliminate the Wool and Mohair Payment Program (IV-23, p. 127)						
Budget Authority	0	130	140	150	160	580
Outlays	0	130	140	150	160	580
370 Commerce and Housing						
End Direct and Indirect Subsidies to the Postal Service (V-1, p. 139)						
Budget Authority	890	945	1,015	1,090	1,160	5,100
Outlays	1,290	1,730	2,180	2,470	2,510	10,180
Increase the Share of Private Funds in SBA Loan Guarantees (V-2, p. 141)						
Budget Authority	*	25	75	100	120	320
Outlays	*	25	75	100	120	320
Reduce Federal Financing of Single-Family Homes in Rural Areas (V-6, p. 142)						
Budget Authority	200	100	210	320	450	1,300
Outlays	-35	-35	55	170	290	440

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
400 Transportation						
Reduce Federal Mass Transit Aid **(V-18, p. 159)**						
Budget Authority	2,010	2,050	2,170	2,290	2,410	10,930
Outlays	860	1,170	1,490	1,800	2,170	7,490
Reduce Federal Airport Assistance **(V-20, p. 162)**						
Budget Authority	610	640	670	700	730	3,350
Outlays	120	410	550	640	690	2,410
Cancel Low-Density Amtrak Services **(V-26, p. 170)**						
Budget Authority	280	300	310	330	340	1,560
Outlays	270	300	310	320	340	1,540
Reduce NASA's Aeronautical Research and Development **(V-29, p. 173)**						
Budget Authority	390	400	420	440	460	2,110
Outlays	260	370	400	430	440	1,900
Establish User Fees for Certain Coast Guard Services **(V-34, p. 178)**						
Budget Authority	1,050	1,100	1,150	1,150	1,200	5,650
Outlays	1,050	1,100	1,150	1,150	1,200	5,650

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
450 Community and Regional Development						
Reduce Funding for Community and Economic Development **(V-15, p. 155)**						
Budget Authority	1,000	1,050	1,100	1,150	1,200	5,500
Outlays	50	450	900	1,040	1,110	3,550
500 Education, Training, Employment and Social Services						
Reduce the Subsidy for GSL Lenders **(IV-18, p. 122)**						
Budget Authority	-30	110	110	100	100	390
Outlays	0	110	110	100	100	420
Reduce Student Loan Default Costs **(IV-19), p. 123)**						
Budget Authority	95	110	110	110	110	535
Outlays	95	110	110	110	110	535
Reduce and Retarget Dependent-Care Aid **(V-7, p. 146)**						
Revenue Gain	90	920	1,080	1,240	1,440	4,770
Outlays	-45	-460	-540	-620	-720	-2,385
Net Savings	45	460	540	620	720	2,385

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services						
Narrow Elementary and Secondary Education Aid **(V-8, p. 148)**						
Budget Authority	260	270	290	300	320	1,440
Outlays	20	200	270	280	300	1,070
Narrow Federal Vocational Education Aid **(V-9, p. 149)**						
Budget Authority	270	290	310	330	350	1,550
Outlays	25	220	290	310	330	1,175
Reduce Federal Support for Non-National Libraries **(V-10, p. 150)**						
Budget Authority	90	100	100	110	110	510
Outlays	20	60	100	100	110	390
Increase States' Cost-Sharing in the WIN Program **(V-11, p. 151)**						
Budget Authority	110	120	130	130	140	630
Outlays	100	120	130	130	140	620

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
550 Health						
Require Coinsurance for All Medicaid Recipients (III-14, p. 79)						
Budget Authority	90	100	100	100	110	500
Outlays	90	100	100	100	110	500
Provide Incentives for Community-Based Care of the Mentally Retarded Under Medicaid (III-15, p. 80)						
Budget Authority	250	570	960	1,450	2,050	5,280
Outlays	250	570	960	1,450	2,050	5,280
Continue Penalties for Large Increases in State Medicaid Spending (III-16, p. 81)						
Budget Authority	520	320	420	510	620	2,390
Outlays	520	320	420	510	620	2,390
Reduce Federal Support for Biomedical Research (V-27, p. 171)						
Budget Authority	480	500	530	560	590	2,660
Outlays	260	490	520	550	580	2,400

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
570 Medical Insurance						
Freeze Physicians' Fees Paid by Medicare **(III-1, p. 66)**						
Budget Authority	830	950	1,100	1,250	1,400	5,530
Outlays	790	910	1,050	1,150	1,350	5,250
Limit Medicare's Reimbursement to Physicians for Inpatient Medical Care **(III-2, p. 67)**						
Budget Authority	430	500	570	660	750	2,910
Outlays	410	470	540	630	720	2,770
Adopt Fee Schedules for Physicians **(III-3, p. 68)**						
Budget Authority	1,400	1,500	1,700	1,900	2,150	8,650
Outlays	1,350	1,400	1,600	1,800	2,050	8,200
Limit Increases in Medicare's Prospective Payment Rates **(III-4, p. 69)**						
Budget Authority	-25	-100	-250	-330	-550	-1,255
Outlays	410	920	1,550	2,300	3,150	8,330
Reduce Medicare's Payments for Direct Medical Education Expenses **(III-5, p. 70)**						
Budget Authority	-5	-30	-65	-65	-100	-265
Outlays	240	260	290	320	360	1,470

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
570 Medical Insurance						
Disallow Revaluation of Hospital Assets Under Medicare **(III-6, p. 71)**						
Budget Authority	*	*	-10	-10	-20	-40
Outlays	50	110	170	220	280	830
Limit Medicare's Payments for Excess Hospital Admissions **(III-7, p. 72)**						
Budget Authority	-15	-60	-140	-180	-300	-695
Outlays	250	510	820	1,250	1,700	4,530
Include Nursing Home and Home Health Payments in Medicare's Hospital Payment Rates **(III-8, p. 73)**						
Budget Authority	-5	-30	-80	-110	-190	-415
Outlays	130	300	530	820	1,110	2,880
Increase the SMI Premium **(III-9, p. 74)**						
Budget Authority	890	1,700	2,400	3,250	4,250	12,490
Outlays	890	1,700	2,400	3.250	4,250	12,490
Increase the SMI Deductible **(III-10, p. 75)**						
Budget Authority	240	400	600	800	950	2,990
Outlays	200	350	550	750	900	2,750

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
570 Medical Insurance						
Expand Coinsurance for Hospital Care (III-11, p. 76)						
Budget Authority	-100	-320	-600	-610	-860	-2,490
Outlays	1,600	1,800	2,100	2,350	2,600	10,450
Increase Cost Sharing Through the Hospital Deductible (III-12, p. 77)						
Budget Authority	-270	-560	-930	-980	-1,350	-4,090
Outlays	1,900	2,200	2,550	2,900	3,350	12,900
Require All Payers to Limit Hospital Payments (III-18), p. 84)						
Budget Authority	-20	-90	-220	-290	-480	-1,100
Outlays	370	780	1,350	2,000	2,700	7,200
600 Income Security						
Modify Civil Service Retirement Provisions (IV-9, p. 112)						
Budget Authority	800	1,500	1,600	1,500	1,400	6,800
Outlays	260	930	1,150	1,350	1,560	5,250
Revenue Loss	-800	-800	-800	-600	-600	-3,600
Net Savings	-540	130	350	750	960	1,650

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
600 Income Security						
Require a Two-Week Waiting Period for Unemployment Insurance Benefits **(IV-11, p. 115)**						
Budget Authority	0	0	0	0	0	0
Outlays	0	930	940	970	1,000	3,800
End Trade Adjustment Assistance Income Benefits **(IV-12, p. 116)**						
Budget Authority	60	100	100	100	100	460
Outlays	60	100	100	100	100	460
Revise Treatment of Lump-Sum Additions to Income in Assistance Payments **(IV-14, p. 118)**						
Budget Authority	35	50	50	50	50	235
Outlays	35	50	50	50	50	235
Require Withholding of Child Support Enforcement Payments From Wages **(IV-15, p. 119)**						
Budget Authority	5	25	35	40	40	145
Outlays	5	25	35	40	40	145

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
600 Income Security						
Require States to Contribute to Food Stamp Benefits **(IV-16, p. 120)**						
Budget Authority	1,000	1,100	1,100	1,150	1,250	5,600
Outlays	1,000	1,100	1,100	1,150	1,250	5,600
Reduce the Subsidy for Nonpoor Children in the Child Nutrition Programs **(IV-17, p. 121)**						
Budget Authority	260	270	280	290	310	1,410
Outlays	260	270	280	290	310	1,410
Eliminate the Earned Income Tax Credit **(IV-20, p. 124)**						
Revenue Gain	10	260	220	180	170	840
Outlays	30	940	920	870	800	3,560
Net Savings	40	1,200	1,140	1,050	970	4,400
650 Social Security						
Eliminate COLAs in Non-Means-Tested Programs for One Year **(IV-1, p. 101)**						
Budget Authority	230	585	-130	-735	-1,235	-1,285
Outlays	7,120	10,590	10,710	10,600	10,320	49,340

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
650 Social Security						
Reduce COLAs in Non-Means-Tested Programs to Two-Thirds of CPI Increase **(IV-2, p. 103)**						
Budget Authority	35	215	240	35	-285	245
Outlays	2,395	6,370	10,610	14,910	19,020	53,305
Reduce COLAs in Non-Means-Tested Programs to CPI Increase Minus Two Percentage Points **(IV-2, p. 103)**						
Budget Authority	65	320	355	140	-195	685
Outlays	2,960	7,780	12,770	17,940	23,310	64,760
End Indexing of Social Security Dependents' Benefits **(IV-3, p. 105)**						
Budget Authority	-25	-120	-270	-450	-750	-1,615
Outlays	620	1,500	2,400	3,300	4,100	11,920
Limit Increase in the Social Security "Bend Points" **(IV-4, p. 106)**						
Budget Authority	0	-5	-20	-40	-80	-145
Outlays	10	100	200	400	700	1,410
Lengthen the Social Security Benefit Computation Period by Three Years **(IV-5, p. 108)**						
Budget Authority	0	-5	-25	-50	-95	-175
Outlays	30	100	300	500	700	1,630

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
650 Social Security						
Eliminate Social Security Benefits for Children of Retirees Aged 62-64 **(IV-6, p. 109)**						
Budget Authority	-5	-15	-35	-70	-120	-245
Outlays	50	200	375	625	700	1,950
Tighten Limitation Family Benefits for OASI Recipients **(IV-7, p. 110)**						
Budget Authority	-5	-20	-45	-85	-140	-295
Outlays	75	250	450	680	950	2,405
Increase the Waiting Period for Social Security Disability Insurance Benefits to Six Months **(IV-8, p. 111)**						
Budget Authority	-20	-35	-45	-55	-75	-230
Outlays	150	160	160	170	180	820
700 Veterans Benefits and Services						
Eliminate Veterans' Compensation Payments for Those With Low-Rated Disabilities **(IV-13, p. 117)**						
Budget Authority	1,250	1,300	1,350	1,400	1,450	6,750
Outlays	1,150	1,300	1,350	1,400	1,450	6,650

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
700 Veterans Benefits and Services						
Require Cost-Sharing for VA Hospital Care **(V-12, p. 152)**						
Budget Authority	90	220	275	330	375	1,290
Outlays	90	220	275	330	375	1,290
Convert Underused VA Hospital Acute-Care Beds **(V-13, p. 153)**						
Budget Authority	45	45	165	165	170	590
Outlays	40	70	100	90	115	415
750 Administration of Justice						
End Funding for Legal Services and Juvenile Programs **(V-14, p. 154)**						
Budget Authority	375	390	415	440	460	2,080
Outlays	280	360	405	435	455	1,935
850 General Purpose Fiscal Assistance						
Limit General Revenue Sharing to Jurisdictions Experiencing Fiscal Distress **(IV-24, p. 128)**						
Budget Authority	1,350	1,350	1,450	1,500	1,600	7,250
Outlays	1,050	1,350	1,450	1,500	1,550	6,900

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
All Functions						
Modify the Davis-Bacon Act **(V-16, p. 156)**						
Budget Authority	685	720	760	800	835	3,800
Outlays	205	440	580	660	725	2,610
Change Overtime Provisions for Federal Contracts **(V-17, p. 158)**						
Budget Authority	610	630	660	690	720	3,310
Outlays	70	310	530	620	670	2,200
Freeze Federal Pay in 1985 **(V-35, p. 179)**						
Budget Authority	1,670	1,890	2,000	2,110	2,230	9,900
Outlays	1,700	1,970	2,080	2,200	2,320	10,270
Delay Within-Grade Federal Pay Raises **(V-35, p. 179)**						
Budget Authority	280	590	1,050	1,920	2,570	6,410
Outlays	280	590	1,050	1,920	2,570	6,410
Delay Annual Federal Pay Adjustments **(V-35, p. 179)**						
Budget Authority	460	770	840	870	900	3,840
Outlays	460	780	850	880	910	3,880

TABLE A-1.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
All Functions						
Modify Personnel and Property Management Practices **(V-36, p.181)**						
Budget Authority	45	450	990	1,350	1,580	4,415
Outlays	20	185	520	840	1,070	2,635

TABLE A-2. ILLUSTRATIVE REVENUE GAINS OVER CBO BASELINE PROJECTIONS, BY BUDGET FUNCTION, FISCAL YEARS 1985-1989
(In billions of dollars)

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
150 International Affairs						
Repeal Domestic International Sales Corporations **(VI-12, p. 214)**	0.9	2.0	2.5	2.7	2.9	10.9
250 General Science, Space, and Technology						
Repeal Credit for Incremental Research Expenditures **(VI-13, p. 215)**	0.3	0.4	*	*	*	0.8
270 Energy						
Impose Tax on Domestic and Imported Oil **(VI-25, p. 229)**	5.7	8.3	8.4	8.4	8.5	39.3
Impose Oil Import Fee **(VI-25, p. 229)**	2.5	3.7	3.5	3.6	3.7	17.0
Impose Excise Tax on Natural Gas **(VI-25, p. 229)**	2.6	3.8	3.7	3.7	3.7	17.5
Impose Broad-Based Tax on Domestic Energy **(VI-25, p. 229)**	10.7	16.1	17.3	18.6	20.2	82.9

NOTE: An asterisk in this table indicates less than $50 million.

TABLE A-2.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
270 Energy						
Repeal Percentage Depletion Allowance **(VI-26, p.234)**	0.6	1.1	1.2	1.3	1.3	5.5
Repeal Expensing of Intangible Drilling Costs **(VI-26, p. 234)**	3.1	5.4	5.1	5.0	4.9	23.5
Repeal Energy Tax Incentives **(VI-27, p. 236)**	0.4	1.3	0.4	0.3	0.3	2.7
300 Natural Resources and Environment						
Eliminate Capital Gains Treatment of Timber **(VI-14, p. 216)**	0.3	0.7	0.8	0.8	0.8	3.4
370 Commerce and Housing						
Limit Itemized Interest Deductions to $10,000 for Joint Returns ($7,500 for Others) **(VI-1, p. 200)**	0.3	2.0	2.2	2.4	2.6	9.5
Tax the Accrued Interest on Life Insurance Reserves **(VI-2, p. 201)**	2.1	5.7	6.2	6.8	7.5	28.4

TABLE A-2.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
370 Commerce and Housing						
Repeal Net Interest Exclusion **(VI-3, p. 202)**	1.0	2.9	3.1	3.4	3.6	14.0
Eliminate Tax-Exempt Revenue Bonds **(VI-15, p. 217)**	0.4	1.5	2.9	4.1	5.4	14.2
Restrict Tax-Motivated Leasing by Nonprofit Institutions **(VI-16, p. 220)**	1.0	1.7	3.1	4.9	5.3	16.0
Repeal the Deduction for Excess Bad-Debt Reserves **(VI-17, p. 221)**	0.6	0.9	1.0	1.0	1.1	4.5
Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities **(VI-18, p. 222)**	0.2	0.5	1.0	1.4	1.9	5.0
Treat Credit Unions Like Other Thrift Institutions **(VI-19, p. 223)**	0.1	0.2	0.2	0.2	0.3	1.0
Lengthen Building Depreciation from 15 to 20 Years **(VI-20, p. 224)**	0.3	1.3	2.5	3.6	4.9	12.6

TABLE A-2.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
370 Commerce and Housing						
Repeal Reduced Rates on the First $100,000 of Corporate Income **(VI-21, p. 225)**	4.8	8.7	9.4	9.8	10.1	42.8
Require Full Basis Adjustment for the Investment Tax Credit **(VI-22, p. 226)**	0.4	1.5	2.8	4.1	5.5	14.3
400 Transportation						
Increase Aviation User Fees **(V-19, p. 161)**	0.9	1.0	1.0	1.0	1.0	4.9
Raise Highway Taxes to Match Highway Outlays **(V-21, p. 164)**	0.7	0.8	1.4	2.1	3.5	8.5
Increase Gasoline Excise Tax **(VI-25, p. 229)**	3.2	4.4	4.4	4.4	4.3	20.7
450 Community and Regional Development						
Limit Rehabilitation Tax Credits to Historic Buildings **(VI-23, p. 227)**	0.2	0.4	0.5	0.6	0.7	2.4

TABLE A-2.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services						
Repeal the Tax Credit for Employee Stock Ownership Plans **(VI-24, p. 228)**	1.3	2.2	2.3	1.0	*	6.8
550 Health						
Tax Some Employer-Paid Health Insurance **(III-17, p. 82)**	1.8	3.5	4.7	6.1	7.8	23.9
570 Medical Insurance						
Tax Premiums for "Medigap" Policies **(III-13, p. 78)**	2.8	4.1	4.6	5.3	6.0	22.8
Increase the Hospital Insurance Payroll Tax **(III-19, p. 85)**	16.9	18.4	19.2	20.4	21.8	96.7
600 Income Security						
Index the Unemployment Insurance Taxable Wage Base **(IV-10, p. 114)**	0.2	1.0	1.8	2.7	3.7	9.4

TABLE A-2.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
600 Income Security						
Eliminate Extra Tax Exemption for the Elderly **(VI-7, p. 208)**	0.9	2.6	2.7	2.9	3.0	12.1
650 Social Security						
Increase Taxation of Entitlement Benefits **(VI-6, p. 205)**	3.8	10.5	10.9	11.0	11.2	47.4
850 General Purpose Fiscal Assistance						
Eliminate Deductibility of State and Local Sales Taxes **(VI-9, p. 210)**	0.8	5.6	6.3	7.2	8.1	28.0
Options Not Assignable to a Function						
Tax Fringe Benefits **(VI-4, p. 203)**	0.5	0.7	0.8	0.9	1.0	3.9
Repeal Charitable Deduction for Nonitemizers **(VI-5, p. 204)**	0.2	1.7	2.8	0	0	4.7
Improve Taxpayer Compliance **(VI-10, p. 211)**	2.9	5.4	6.7	8.9	11.4	35.3

TABLE A-2.

Budget Function/Options	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Speed Settlement of Tax Court Cases (VI-11, p. 213)	*	0.1	0.1	0.1	0.1	0.4
Increase Excise Taxes (VI-28, p. 238)	2.6	6.8	7.9	10.0	11.6	38.9
Freeze Estate and Gift Credit and Tax Rates (VI-29, p. 241)	0	0.9	1.7	2.5	3.1	8.2
Eliminate Income Averaging (VI-8, p. 209)	1.3	5.5	5.9	6.4	6.9	26.0

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